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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF UNS GAS, INC. DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-04204A-06-0463
IN THE MATTER OF THE APPLICATION OF UNS GAS, INC. TO REVIEW AND REVISE ITS PURCHASED GAS ADJUSTOR.	DOCKET NO. G-04204A-06-0013
IN THE MATTER OF THE INQUIRY INTO THE PRUDENCE OF THE GAS PROCUREMENT PRACTICES OF UNS GAS, INC.	DOCKET NO. G-04204A-05-0831

INITIAL POST-HEARING BRIEF

OF UNS GAS, INC.

Arizona Corporation Commission
DOCKETED
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JUNE 5, 2007

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UNS Gas, Inc. ("UNS Gas" or "Company"), through undersigned counsel, hereby submits its Initial Post-Hearing Brief in support of its requested relief in the following consolidated dockets: (i) G-04204A-06-0463 (the "UNS Gas Rate Case"); (ii) G-04204A-06-0013 (the "PGA Review Case") and (iii) G-04204A-05-0831 the ("Gas Procurement Review Case"), collectively referred to as the "UNS Gas Rate Case". In support hereof, UNS Gas states as follows:

INTRODUCTION.

On July 13, 2006, UNS Gas filed its application for the establishment of just and reasonable rate for UNS Gas. This is the first UNS Gas Rate Case since the Company acquired Citizens Utilities' ("Citizens") Arizona gas assets in 2003. UNS Gas is under a rate moratorium that expires in July 2007. During the rate moratorium, UNS Gas has faced numerous financial and operational challenges that have jeopardized its viability. UNS Gas requests that the Commission take the necessary steps to ensure that UNS Gas remains a viable gas company for present and future customers. As UNS Gas witness Mr. James S. Pignatelli stated at the hearing:

> We do believe, though, that what we have requested here is the bare bones rate increase. It's what we need to continue to have a viable entity charged with providing safe and reliable service.
>
> . . .
>
> I can tell you that if we got RUCO's $2.7 million increase after tax, that would be about a million and a half dollars. That would bring that 4 million to 5.5 on -- probably at that time it would be more like 90 or 100 million in equity. That's not a fair return.
>
> I can tell you if we got Staff every cent of what Staff requested, 4.5 million, after tax that's about 3 million. You add that to 4, that gives us 7 million on 100 million. That's after tax 7 percent. That's not a fair return.
>
> We have to work together to come to the right conclusion. I believe that we have done a fine job in maintaining a high level of service while our costs have skyrocketed. We held out rate relief for three years. Current rates reflect 2001, at best, costs. We need relief.[1]

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[1] Hearing Transcript ("Tr.") at 52-55.

On January 10, 2006, UNS Gas filed an application requesting that the Arizona Corporation Commission ("Commission") review and revise its Purchased Gas Adjustor ("PGA"). On September 8, 2006, the Commission consolidated the PGA Review Case with the UNS Gas Rate Case. The revisions UNS Gas is requesting will provide for more timely recovery of the Company's gas commodity-related costs.

On November 10, 2005, the Commission opened the Gas Procurement Review Case to review the prudence of the gas procurement practices of UNS Gas. On September 8, 2006, the Commission consolidated the Gas Procurement Review Case with the UNS Gas Rate Case. The Gas Procurement Review Case was intended to determine whether UNS Gas' past gas procurement practices were prudent.

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A. Overview of Gas Rate Case.

UNS Gas is requesting: (i) a base rate increase of $9.6 million, or approximately 7 percent; (ii) key changes to its rate design that allow UNS Gas to cover more of its fixed costs through a higher monthly customer charge and reduce the current subsidization of warm-weather customers by cold-weather customers; (iii) adoption of a rate decoupling mechanism addressing the *volume* of gas sold to help UNS Gas more timely recover fixed costs (UNS Gas has referred to this mechanism as the "Throughput Adjustment Mechanism" or "TAM"); and (iv) the inclusion of Construction Work in Progress ("CWIP") in rate base to keep up with customer growth.

A brief overview of some significant aspects of the Company's rate request is provided herein to demonstrate the broad scope of relief that is necessary for UNS Gas to meet the needs of its customers in the future.

UNS Gas requests that $7.2 million in CWIP be included in rate base. This CWIP is the result of unprecedented growth that has occurred in the UNS Gas service area. Since UNS Gas acquired the gas assets, it has made over $50 million in capital improvements. UNS Gas anticipates that it will continue to make substantial capital investments for the foreseeable future. Unless CWIP is included in rate base, UNS Gas will suffer inadequate returns on its investment and a deteriorating financial condition

UNS Gas also requests recovery of its Geographic Information System ("GIS") and software in costs. There is no dispute that this system is critical to the safe, efficient and reliable operation of the gas facilities. However, other parties contest its inclusion due to an honest accounting error for this significant investment. UNS Gas believes it is fair and appropriate to include this valuable system in our rate base.

UNS Gas requests a return on equity ("ROE") of 11 percent. UNS Gas is by no means a large company. However, it faces the same significant challenges and related risks that larger gas companies face, due to factors such as high growth and unstable gas prices. The 11 percent ROE is both reasonable and necessary to attract the capital needed by UNS Gas.

UNS Gas proposes changes to its rate design because a large portion of its fixed costs are being covered by revenues that are dependant upon volumetric usage charges. The cost of serving individual customers does not vary significantly based on the amount of gas they use; UNS Gas incurs the fixed costs regardless of whether it sells a single cubic foot of gas. However, the current rate design compels high-usage customers – typically those living in the colder areas of UNS Gas' service territory – to pay a greater share of the Company's fixed costs than low-usage customers in warmer climates. UNS Gas has proposed increasing the fixed monthly customer charge and decreasing the volumetric charge to reduce this substantial cross-subsidization.

Despite the higher monthly customer charge, a portion of the Company's fixed costs would continue to be recovered through the volumetric margin charge. The proposed TAM would monitor the recovery of those costs and adjust rates up or down to ensure that usage-based revenues more accurately track anticipated levels. In this way, the TAM would ensure that UNS Gas does not over-earn or under-earn as a result of the sales volumes being higher or lower than anticipated.

UNS Gas believes the relief it is requesting is fair, just and reasonable. First, UNS Gas has experienced annual customer growth exceeding 5 percent. Second, UNS Gas' cost of providing service has increased, accentuated by volatile wholesale gas costs that have reached unprecedented price spikes. Third, UNS Gas is involved in increased efforts to reduce consumption of gas

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through conservation, demand-side management and other energy efficiency initiatives. The success of these efforts will lead to lower revenues, particularly given UNS Gas' current rate design, which attempts to recover the bulk of the Company's fixed costs through volumetric charges.

To date, UNS Gas has managed to meet the challenges of growth and the gas market, mostly through tight budgeting and capital infusion by its ultimate parent company, UniSource Energy Corporation ("UniSource Energy"). But without adequate rate relief to cover the cost of capital and other expenses, it is unlikely that any serious investor would continue to infuse money into UNS Gas.[2]

B. Overview of PGA Review.

UNS Gas is seeking to have its PGA reviewed and revised, and has requested the following modifications to its current PGA: (i) the bandwidth should be eliminated or, in the alternative, temporarily increased to $.25 per therm, and then eliminated; (ii) the interest earned on the PGA bank balance should reflect UNS Gas' actual cost of new debt, which is LIBOR plus 1.5 percent, (iii) when the bank balance is greater than two times the threshold level, UNS Gas should earn its weighted average cost of capital as determined in its most recent rate case; (iv) a new threshold level of $6,240,000 should be adopted for over-collected bank balances; (v) debt related to the bank balance in UNS Gas' capital structure should be excluded for the purpose of calculating UNS Gas' weighted average cost of capital; and (iv) when surcharges are needed, the surcharge should be large enough to eliminate the bank balance within a reasonable time period. Such revisions are particularly important in times of volatile gas prices.

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[2] Attachment 1 to this brief is an updated version of Exhibit DJD-1, which provides a comparative summary of the adjustments to rate base, to operating income and to operating expenses that reflects the Company's final position on those adjustments as set forth in Rejoinder Testimony. The Company's final position is also set forth in the schedules that are being submitted along with this brief.

C. Overview of Gas Procurement Review.

The Commission Utilities Division Staff ("Staff") initiated the review of UNS Gas' gas procurement practices. After its review, Staff has concluded that UNS Gas' gas procurement policies and practices are prudent. UNS Gas concurs with Staff's conclusion. UNS Gas also is requesting in this docket that the Commission approve its gas procurement policies (the "Price Stabilization Policy") on a going forward basis.

I. UNS GAS' REVENUE REQUIREMENT AND RELATED RATE INCREASE IS JUST AND REASONABLE.

UNS Gas has requested a rate increase of $9,646,901, or approximately 7 percent. Its current rates are insufficient to allow the Company to recover its costs and earn a reasonable rate of return on its investment. This is due to increased growth in UNS Gas' service territory and the related increase in capital expenditures and operating costs. UNS Gas has an original cost test year rate base of $161,661,362, a fair value test year rate base of $191,177,715, and an adjusted test year net operating income of $8,429,000. The Company also seeks an overall rate of return ("ROR") and weighted average cost of capital of 8.80 percent. This overall ROR is based on a 6.6 percent cost of debt, an 11.0 percent cost of common equity capital, and a capital structure consisting of 50 percent long-term debt and 50 percent common equity. The rate of return on fair value rate base is 7.43 percent.

Based on its requested rate base, current operating income and requested rate of return, UNS Gas presently has an operating income deficiency of $5,794,198, thus entitling it to an increase in revenues of $9,646,901. Absent a rate increase, UNS Gas has projected it will earn a return on average common equity without adjustments or allocations of 4.53 percent in 2006.

A. UNS Gas' Proposed Rate Base is Reasonable.

Due to agreements made in the course of UniSource Energy's acquisition of Citizens' assets, UNS Gas' current rates are based upon an original cost less depreciation rate base of $117,661,030. Since then, UNS Gas has spent $61,616,006 through the end of the test year on its transmission and distribution facilities. Most of this investment has been related to growth in its

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natural gas system. UNS Gas has made substantial additions to utility plant and equipment that have improved service reliability for existing customers while meeting the demand of customer growth.

UNS Gas requests an original cost test year rate base of $161,661,362 and a fair value test year rate base of $191,177,715. UNS Gas provided the information pursuant to three valuation methodologies: (i) original cost; (ii) reconstruction cost new less depreciation ("RCND"); and (iii) fair value. Pursuant to Commission precedent, the fair value was determined by adding together original cost and RCND rate base amounts and dividing that total by two.

There are few issues with UNS Gas' rate base. Staff challenged only two adjustments directly: the CWIP adjustment and the GIS adjustment. RUCO raised several other challenges to rate base that neither UNS Gas nor Staff support.

1. Methods for protecting UNS Gas' financial integrity in the face of extraordinary growth.

UNS Gas faces the real and significant risk of financial deterioration without adequate rate relief. It is undisputed that UNS Gas has faced, and will continue to face, high levels of growth.[3] UNS Gas has a low embedded cost of plant, so rate base per customer is much higher for new customers than for existing customers.[4] Thus, extra revenue from new customers will not be sufficient to cover the capital costs required to serve them. Therefore, UNS Gas will likely be unable to earn its authorized rate of return in the foreseeable future.[5] Yet, UNS Gas faces very high capital expenditure requirements.[6] It is essential that UNS Gas maintain an ability to attract capital to meet these capital expenditure requirements.

UNS Gas proposes several measures to reduce the detrimental financial impact of these high capital requirements. These proposed measures include tariff changes to increase contributions from developers, thereby somewhat reducing the amount of required investment per

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[3] Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.
[4] Ex. UNSG-28 at 8; Tr. at 956.
[5] Ex. UNSG-28 at 8.
[6] Id.

customer. Such proposals are beneficial, to an extent, and help ease the burden of attracting new capital.

Even with these proposals, however, UNS Gas will need to attract tens of millions of dollars in new capital in the next few years.[7] Without a timely way to recover these capital expenditures, UNS Gas' financial integrity will suffer, forcing it to file rate cases in rapid succession. There is a better way to protect UNS Gas' financial integrity, while providing a bit of breathing room between rate cases. To do so, the Commission must use tools that, while legally permissible and within the Commission's discretion, are often shunned.

a. Construction Work in Progress.

UNS Gas' primary request is to include CWIP in rate base. CWIP is an accepted aspect of ratemaking that has been used in many states for many years.[8] There is nothing novel or cutting edge about it. Indeed, the Arizona Supreme Court has specifically ruled that the Commission may include CWIP in rate base. *Arizona Community Action Assoc. v. Arizona Corp. Comm'n*, 123 Ariz. 228, 230, 599 P.2d 184, 186 (1979). The court referred to one of its earlier decisions which found the use of CWIP to be within the Commission's discretion. Quoting that earlier decision, the Court remarked: "[it] appears to be in the public interest to have stability in the rate structure within the bounds of fairness and equity rather than a constant series of rate hearings." *Id.*

Such is the case here. Again, UNS Gas will not be able to earn its authorized rate of return, even if its full rate request is approved, due to growth and a higher rate base per customer for new customers. Including CWIP in rate base will help address this problem.

RUCO claims that growth is positive, generating "more revenue and cash flow."[9] Staff argues along the same lines. These assertions may be true in a generic sense, but they do not fit the circumstances of UNS Gas. As already described, the higher capital costs associated with new UNS Gas customers creates a severe drain on the Company's financial integrity. It also negatively

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[7] See, e.g., Ex. UNSG-27 at 27 ($43 million in additional capitalization through 2009); Ex. UNSG-15 at 4 (noting more than $61 million in capital spending from 2001 to 2005).
[8] Ex. UNSG-28 at 7.
[9] Ex. RUCO-5 at 9.

impacts cash flow, because new plant creates additional fixed costs, and because growth leads to capital requirements far in excess of the Company's internal cash flow.[10] As a result, the "impact of regulatory lag on UNS Gas is more pronounced than most utilities."[11]

UNS Gas' financial data clearly shows the negative financial effects of growth. For example, in 2006, UNS Gas added $17 million in net plant, resulting in an additional $3 million in fixed costs (depreciation, property taxes, etc).[12] But new customers added in 2006 provided only $1.8 million in new revenues.[13] Therefore, UNS Gas lost $1.2 million due to new growth in 2006.[14] Notably, Staff and RUCO did not dispute this example in their testimony.

b. Post Test Year Plant.

If the Commission does not allow CWIP into rate base, then it should include post test year plant in rate base. The Commission approved post test year plant in a number of recent cases.[15] UNS Gas faces faster growth than other utilities in Arizona[16] and the required amount of capital per customer is much higher for new customers than for existing customers. Given the large number of other cases approving post test year plant, it is certainly justified in this case. Therefore, if the Commission does not allow CWIP, it should include post test year plant in rate base.

c. Customer Advances should have no net impact on rate base.

If the Commission rejects both CWIP and post test year plant from rate base, it should at the very least ensure that rate base is not reduced even more from customer advances related to CWIP. Customer advances are funds provided by customers to pay for new facilities. Typically, advances are deducted from rate base. The theory behind this is clear: advances are customer-

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[10] Ex. UNSG-28 at 9.
[11] Ex. UNSG-27 at 28.
[12] Ex. UNSG-28 at 10.
[13] Id.
[14] Id.
[15] *See e.g., Arizona-American Water Co. (Paradise Valley),* Decision No. 68858 (July 28, 2006); *Chaparral City Water Co.,* Decision No. 68176 (September 30, 2005); *Rio Rico Utilities, Inc.*, Decision No. 67279 (October 5, 2004); *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004); *Arizona Water Co.*, Decision No. 66849 (March 19, 2004); *Bella Vista Water Co., Inc.*, Decision No. 65350 (November 1, 2002).
[16] Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.

supplied capital and should reduce rate base. For example, if a customer advances $1,000 for new facilities that are in service, the net impact should be zero (plant in service increases by $1,000; rate base then decreases by $1,000 for a zero net impact).

UNS Gas requests $7 million in CWIP.[17] UNS Gas received $4 million in advances related to this CWIP.[18] Thus, if CWIP is allowed in rate base, the net impact will be $3 million ($7 million less $4 million in advances). But if CWIP is denied, then there is no reason to deduct the $4 million from rate base. Staff and RUCO suggest that this $4 million still be deducted from rate base. Under their proposal, the net impact of the advances will be a $4 million reduction in rate base ($0 million in extra plant in service, less $4 million in advances).

That proposal is simply unfair. It would be bad enough if UNS Gas must forego recovery of the capital costs on $7 million in plant, which is almost entirely in service today.[19] Under the Staff / RUCO approach, UNS Gas would be required to forego recovery of a further $4 million. The effect is to substitute $4 million of "cost free" capital that financed test year CWIP for real debt and equity capital that financed test year plant in service.

There is no rule that requires advances to be deducted from rate base when the related plant is not yet in service. The purpose of deducting advances from rate base is to recognize the effect of customer-supplied capital. That purpose is not served when the plant funded by the advances is not in service. RUCO recently recognized this when it agreed that contributions collected to fund a water treatment plant should not be deducted from rate base until that plant is in service.[20] In that case, RUCO's witness also suggested that the same rationale could apply to other cases.[21] While RUCO does not make that recommendation in this case, the same considerations suggest that a $4 million reduction in rate base is not warranted unless the related plant is recognized in plant in service.

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[17] Ex. UNSG-29 at 9.
[18] Id.
[19] Thus, AFUDC accruals have ceased.
[20] Tr. at 1005-1006.
[21] Ex. UNSG-36.

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Moreover, some Commissioners have suggested that some utilities should collect more advances and contributions through mechanisms like hook-up fees. Taken in moderation, such proposals are beneficial, providing "cost free" capital for new construction. The additional plant funded by hook-up fees results in no net change in rate base. Such proposals become a poisoned chalice, though, if they lead to net decreases in rate base. Under those circumstances, the Commission would be sending an economic signal that utilities should try as hard a possible to avoid advances and contributions. Such a result would not serve the public interest.

2. Geographic Information System.

UNS Gas has aggressively increased productivity to lower costs to its customers. From the date of the purchase of the gas system to the end of the test year, UNS Gas increased productivity by nearly 11 percent.[22] For example, UNS Gas moved from needing one employee for every 616 customers to needing only one employee for every 666 customers.[23] These productivity gains created savings of $1.8 million – a direct benefit to ratepayers.[24]

A core strategy for increasing productivity is the increased use of information technology. The best example of this is UNS Gas' new Geographic Information System ("GIS").[25] The GIS creates many benefits, including:

(i) faster emergency response due to the ability to quickly locate system controls (such as valves);

(ii) better informed planning through computer modeling of the gas system;

(iii) faster work processes, including quicker mapping of the system, which is especially important in a fast-growing system; and

(iv) increased accuracy and safety because field employees can access up-to-date maps on their portable computers.[26]

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[22] Ex. UNSG-15 at 8.
[23] Id.
[24] Id.
[25] Id. at 6.
[26] Id. at 6-7.

The GIS therefore provides clear benefits in safety and productivity that benefit customers. A key question in this case is how the costs of the GIS should be recovered. The answer offered by Staff and RUCO, that no recovery should be allowed, is simple but unfair. UNS Gas suggests that the Commission treat the GIS costs as a regulatory asset, to be amortized over the estimated period rates from this case will be in place.[27]

Staff and RUCO justify their complete disallowance of GIS costs by noting that UNS Gas did not obtain an accounting order authorizing the deferral of the GIS costs.[28] UNS Gas requests that the Commission retroactively approve such a deferral. All parties agree that approval of a deferral would be needed because GIS costs ordinarily would be treated as expenses.

UNS Gas did not seek an accounting order earlier due to a mistake. Originally, the work orders relating to the project were prepared on the assumption that the project would be capitalized, not expensed.[29] These work orders were created by Citizens and UNS Gas did not discover this mistake when the work orders were converted to UNS Gas work orders.[30]

UNS Gas now accepts that the GIS costs should be expensed unless the Commission authorizes a deferral. But this realization came late in the test year, after almost all of the costs had been incurred. Only then did the Company realize that Commission approval of a deferral would be needed.

RUCO and Staff have not said they would have opposed an accounting order if one had been requested earlier, and they have not questioned the amount of GIS costs. Nevertheless, they claim these costs should be disallowed because of a bookkeeping error. Rate cases should reflect the reality of the costs incurred rather than the results of a regulatory game of "gotcha." RUCO's and Staff's proposal unfairly penalizes UNS Gas for an honest mistake and fails to allow recovery of costs that resulted in substantial safety and productivity gains.

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[27] Ex. UNSG-12 at 9-10.
[28] See, e.g., Ex. RUCO-6 at 8-9.
[29] Tr. at 221-22; see Ex. S-6.
[30] Ex. S-6 at 7.

Staff's position is especially harsh given that Staff requested that UNS Gas undertake the GIS project and thus incur these costs.[31] In setting rates, the Commission "must consider" the costs of complying with the Commission's requirements. *Arizona Corp. Comm'n v. Palm Springs Utility Co., Inc.*, 24 Ariz. App. 124, 130, 536 P.2d 245, 251 (1975). Because the GIS costs were incurred at the request of the Commission's representatives, the Commission should allow recovery of these costs.

RUCO also argues that the Company actually did recover its GIS costs in the test year.[32] There is no evidence to support this claim, since even RUCO does not contend that GIS costs were included in the last rate case for the Company. RUCO's argument should therefore be rejected.

3. Plant in Service.

Staff has not challenged UNS Gas' plant in service. However, RUCO proposes disallowing $3.1 million in plant it considers "unsubstantiated." This adjustment should be rejected because UNS Gas provided adequate documentation of these items. RUCO's disallowance appears to relate to the final months the system was owned by Citizens (June through August 2003). By that point, Citizens had agreed to sell the system to UniSource Energy, and Citizens was scrambling to wrap up its accounting for those months.[33] It is not surprising that Citizens' records from that period were less extensive than normal.

However, sufficient detail still exists to verify the final plant in service totals at the closing of the sale. UNS Gas provided RUCO with records from Citizens documenting the final plant in service numbers, as well as electronic files containing a detailed plant listing.[34] RUCO attempts to justify its disallowance through RUCO Exhibit 1, which includes paper documents provided by UNS Gas. However, RUCO Exhibit 1 does not include the electronic files provided to RUCO. Moreover, RUCO's counsel seemed unfamiliar with the existence of these electronic files.[35]

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[31] Id.
[32] Ex. RUCO-6 at 8-9.
[33] Tr. at 197.
[34] Tr. at 194-97.
[35] Id.

Because RUCO Exhibit 1 does not include the electronic files provided to RUCO, it is not reliable evidence.

Moreover, RUCO's witness, Mr. Rodney Moore, said that he "can't imagine" that Citizens added $3 million in plant in its last few months.[36] Yet Mr. Moore admitted that the Company spends more than $1 million per month in capital expenditures;[37] $1 million per month over 3 months amounts to $3 million in additional plant in service.[38]

In addition, Mr. Moore stated that Citizens continued "business as usual" regarding rate base records up to the closing.[39] Thus, Citizens' records for those months should be accepted, just as Citizens' records for the previous months have been accepted by all parties.

Mr. Moore also states that Citizens' rate base records are "notoriously inadequate" and that it "is commonly accepted by those who have attempted (in past proceedings and in the instant case) to establish an accurate rate base... from Citizens' records that these records are inaccurate."[40] Notably, Mr. Moore did not point to any similar adjustments in those prior cases. That is because such adjustments were not made in those prior cases. For example, the rate cases for Citizens' former water and wastewater assets did not have any proposed adjustment similar to that proposed by RUCO here.[41] There are no grounds for treating UNS Gas any differently than other buyers of Citizens' assets.

Further, treating the gas system more harshly than other former Citizens systems makes little sense because the Commission imposed less stringent records retention requirements for the sale of the gas assets. The Commission order approving the sale of the gas system by Citizens did not include standard record retention requirements.[42] Such requirements have been included in orders relating to the sales of other Citizens assets.[43] The absence of these requirements indicates

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[36] Tr. at 653.
[37] Tr. at 658-59.
[38] Id.
[39] Tr. at 644-45.
[40] Ex. RUCO-4 at 4.
[41] See *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004).
[42] Tr. at 644.
[43] Ex. UNSG-7 at 6.

that the Commission likely anticipated that less documentation would be available from Citizens, because the gas and electric systems were the last systems in Arizona to be sold.

UNS Gas directly transferred the final plant in service numbers from Citizens to its books as the opening values for plant in service. The Commission requires UNS Gas to follow FERC accounting standards, and this accounting procedure was expressly approved by FERC.[44] Moreover, UNS Gas' financial statements were audited and approved by a nationally recognized audit firm.[45]

In sum, UNS Gas provided adequate documentation from Citizens to support the full amount of plant in service transferred from Citizens. RUCO appears to have ignored electronic records provided to it. Staff did not support RUCO's adjustment. Moreover, the disputed $3.1 million is consistent with historical capital expenditures during the disputed period. No similar disallowances were made in other rate cases involving former Citizens systems. In addition, UNS Gas' position is consistent with FERC-approved accounting for the transaction and the Company's audited financial statements. Accordingly, RUCO's proposal to disallow more than $3 million in plant should be rejected.

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4. Accumulated Depreciation.

RUCO proposes increasing accumulated depreciation by more than $6.7 million, which has the effect of reducing rate base by the same amount. Staff did not support this adjustment. Because RUCO's adjustments are unfounded, they would have the effect of taking away $6.7 million of property from UNS Gas. There is no support for RUCO's extreme position.

RUCO's adjustment has two parts. First, RUCO used outdated depreciation rates to calculate its accumulated depreciation total. This adjustment totals $2,855,454.[46] Second, RUCO witness Mr. Moore adjusted accumulated depreciation to match his disallowance of "unsubstantiated" plant and to incorporate RUCO's outdated depreciation rates. This adjustment

[44] Ex. UNSG-7 at Ex. KGK-3, Ex. KGK-4.
[45] Ex. UNSG-7 at 2; Ex. UNSG-6 at Ex. KGK-1.
[46] Ex. RUCO-3 at 13-14.

totaled $3,857,413.[47] This adjustment should be rejected for the same reasons RUCO's "unsubstantiated plant" adjustment and first accumulated depreciation adjustments should be rejected.

RUCO suggests that accumulated depreciation should be based on depreciation rates approved in Decision No. 58664 (June 16, 1994)("1994 Rate Order").[48] Those rates predate the test year by more than a decade. RUCO fails to recognize that the Commission approved new depreciation rates in Decision No. 66028 (July 3, 2003)("2003 Rate Order"). The 2003 Rate Order resolved Citizens' gas rate case, and also approved the sale of the gas system.

RUCO argues that the 2003 Rate Order did not expressly approve the new depreciation rates. However, unless a ratemaking proposal is disputed, it is commonplace for the Commission to not explicitly address the proposal.[49] No party disputed the depreciation rates in 2003. While RUCO seems to contend that the 2003 Rate Order was a "black box" settlement, in fact the settlement agreement contained a specific schedule showing how the revenue requirement was calculated.[50] The numbers in this schedule presume the new depreciation rates.[51] The settlement agreement, including the schedule, were approved by the Commission in the 2003 Rate Order.[52] Thus, the new depreciation rates were approved in the 2003 Rate Order.

Moreover, RUCO's insistence on explicit approval language contradicts its own actions in this case. RUCO supports the depreciation rates from the 1994 Rate Order, but that order discusses only two of 28 depreciation accounts.[53] Thus, for the remaining 26 accounts, RUCO had to refer to the rate application to see what depreciation rates were approved.[54] Yet RUCO refuses to take this same step and refer to the rate application that led to the 2003 Rate Order.

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[47] Id. at 12; Ex. RUCO-4 at 6.
[48] Ex. RUCO-3 at 13-14.
[49] Tr. at 201-202.
[50] Ex. UNSG-7 at Ex. KGK-11.
[51] Tr. at 202-203; Ex. UNSG-7 at 9.
[52] Decision No. 66028 (July 3, 2003) at 30.
[53] Tr. at 674.
[54] Id.

In addition, RUCO applied its outdated depreciation rates to the entire gas system. However, prior to the 2003 Rate Order, the gas system was divided into two ratemaking divisions – the Santa Cruz Division, and the Northern Arizona Division.[55] RUCO's witness admitted that the 1994 Rate Order did not apply to the Santa Cruz Division.[56] Therefore, it would not be appropriate to apply those 1994 depreciation rates to the Santa Cruz portion of the gas system, yet that is exactly what RUCO did here.

If RUCO is correct that the 2003 Rate Order did not change depreciation rates, then there are still separate depreciation rates for Santa Cruz County that were unaffected by the 1994 Rate Order. However, that would be inconsistent with the Commission's decision in the 2003 Rate Order to approve unified, statewide rates for the gas system.

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5. Working Capital.

A number of ratemaking adjustments will have an impact that should be recognized in working capital. In addition, RUCO's proposed working capital should be rejected because RUCO failed to use a simultaneous equation to compute two elements of cash working capital: synchronized interest and current income taxes.[57]

6. Accumulated Deferred Income Tax.

RUCO makes two major, but deeply flawed, adjustments to rate base for "unsubstantiated plant" and "unauthorized depreciation rates." Those adjustments should be rejected for the reasons already stated. There is a further flaw in RUCO's approach. While RUCO adjusted current income taxes to reflect its rate base adjustments, RUCO failed to make the corresponding adjustments to accumulated deferred income taxes and to deferred income tax expense.[58] Therefore RUCO's computation of accumulated deferred income taxes and deferred income tax expense should be rejected. This flaw provides a further reason to reject RUCO's "unsubstantiated plant" and "unauthorized depreciation rates" disallowances.

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[55] See Decision No. 66028 (July 3, 2003) at 27.
[56] Tr. at 673.
[57] Ex. UNSG-7 at 12.
[58] Id. at 11-12.

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7. Reconstruction Cost New less Depreciation.

RUCO's calculation of RCND rate base is flawed. RUCO used a ratio of original cost rate base ("OCRB") to RCND.[59] But the proper and widely accepted method is to perform a trending study using the final OCRB as the starting point and then adding increased costs though accepted indexes of inflation, such as the Handy-Whitman Index.[60] Because RUCO failed to use the accepted method of calculating RCND, its RCND rate base should be rejected.

8. Fair Value Rate Base.

UNS Gas, Staff and RUCO agree that fair value rate base ("FVRB") should be calculated by averaging OCRB and RCND. Thus, the Commission should approve this traditional method.

9. Uncontested Adjustments.

The Commission should approve the following uncontested rate base adjustments as shown on Attachment 1: (1) Southern Union Acquisition Premium; (2) Griffith Power Plant; (3) Build-Out Plant; (4) Customer Assistance Residential Energy Support Program ("CARES") asset; (5) customer contributions; (6) Y2K; and (7) Warm Spirit.

B. UNS Gas' Operating Income Determination is Appropriate.

As shown in Attachment 1, UNS Gas proposed six operating revenue adjustments. Staff and RUCO proposed modifications only to the customer annualization and weather normalization adjustments. UNS Gas also proposed 26 operating expense adjustments. Staff and RUCO opposed several of these adjustments and proposed several additional operating adjustments. UNS Gas disagrees with Staff's and RUCO's adjustments and most of their modifications to UNS Gas' adjustments. UNS Gas's adjusted operating income for the test year is $8,428,981, as opposed to Staff's calculation of $9,900,381 and RUCO's calculation of $10,219,499. UNS Gas submits that its adjustments are fully supported by the record and should be adopted by the Commission.

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[59] Ex. RUCO-3 at 9.
[60] Ex. UNSG-6 at 20.

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1. Operating Revenue.

a. Customer Annualization.

UNS Gas is experiencing high growth. However, that growth is not simple straight-line expansion. Instead, the seasonal pattern of UNS Gas' growth is cyclical.[61] UNS Gas' witness, Mr. D. Bentley Erdwurm, graphically demonstrated this cyclical growth rate on his Exhibit DBE-5.[62] As Mr. Erdwurm explained, "in cases of cyclical growth, the mathematics break down and... the practical problem is that [the traditional model] will often give you a totally counterintuitive result, where you would actually have a negative customer adjustment on a growing system."[63] For example, Mr. Erdwurm demonstrated that in certain situations, applying the traditional method to UNS Gas results in negative customer growth for a class that has a positive growth trend, which has the nonsensical effect of pushing rates higher when the customer normalization should lower them.[64]

Due to UNS Gas' cyclical growth pattern, the traditional, simplistic annualization method should be rejected in favor of a slightly more advanced mathematical model based on the exponential growth model.[65] The Company believes that, given the seasonal nature of a significant portion its customer base, the traditional method used to annualize customer adjustments is not as accurate as the Company's proposed methodology. The results under the Company's method make more sense because the standard deviation is lower, producing the more accurate result in UNS Gas' climate.[66] Staff and RUCO offer no justification for rejecting the Company's system other than to say it is not as simplistic and it has not been adopted before. These arguments should not be used as an excuse to sacrifice accuracy. The accuracy of the Company's method justifies its adoption in this case over the traditional method.

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[61] Tr. at 447.
[62] Ex. UNSG-20 at Ex. DBE-5.
[63] Tr. at 447.
[64] Tr. at 447; Ex. UNSG-20 at 4-5.
[65] Ex. UNSG-20 at 3.
[66] Ex. UNSG-19 at 8.

b. **Weather Normalization.**

The weather normalization adjustment should reflect the other positions taken herein, including the customer annualization adjustment described above.

c. **Uncontested Income Adjustments.**

The Commission should approve the following uncontested operating income adjustments as shown on Attachment 1: (1) Griffith Plant Operations; (2) Purchased Gas Adjustor and Gas Cost Revenue; (3) NSP Revenue and Gas Cost; and (4) CARES.

2. **Expenses.**

a. **Legal Standard.**

The Commission is required "to allow a recovery for all reasonable expenses." *Tucson Electric Power Co. v. Arizona Corp. Comm'n,* 132 Ariz. 240, 245, 645 P.2d 231, 236 (1982). In other words, the Commission must provide sufficient income to permit full recovery of "operating costs" in addition to the return on rate base. *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1978). In addition, the Commission "must consider" any "expenditures made in compliance with the Commission's decision[s]." *Arizona Corp. Comm'n v. Palm Springs Utility Co.*, 24 Ariz. App. 124, 536 P.2d 245 (1975).

b. **Property Tax.**

Three elements are needed to calculate property tax: the property's value, the assessment ratio, and the tax rate.[67] RUCO proposes using the 2005 tax rate and property values but a 2007 assessment ratio.[68] While RUCO "feels strongly about avoiding mismatches,"[69] its property tax proposal creates a classic mismatch. Indeed, RUCO's witness, Mr. Moore, admits that actual property taxes never will be calculated using RUCO's method.[70] Instead, taxes for a particular year are calculated using the property value, assessment ratio and tax rate for that year. For example, property taxes never will be calculated using a 2005 tax rate and a 2007 assessment

[67] Tr. at 632; Tr. at 843-44.
[68] Tr. at 633.
[69] Tr. at 632.
[70] Tr. at 635.

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ratio.[71] Yet that is exactly what RUCO proposes in this case. Staff's proposal is identical. The RUCO / Staff adjustment creates a mismatch and should be rejected.

c. Legal Expense.

The dispute over legal expenses concerns expenses for UNS Gas' participation in a FERC rate case for El Paso Natural Gas Company ("El Paso"). No party denies that UNS Gas actually incurred these expenses in the test year. Instead, Staff argues the test year expense level is not normal and should therefore be reduced to eliminate "non-recurring" FERC-related costs. Staff proposes disallowing $311,051 in expenses on that basis.[72]

Staff's adjustment suffers from numerous flaws. Most fundamentally, Staff ignores the fact that UNS Gas must deal with two new rate cases. Transwestern Pipeline Company has already filed a rate case, and El Paso will be filing a new rate case this year.[73] This shows that FERC rate cases are not atypical, non-recurring items. Instead, they are a normal part of the cost of doing business for a gas distribution utility. Staff did not estimate the costs of participating in these new cases,[74] and Staff's adjustment clearly does not include an adequate provision for participating in those new cases.

Staff's adjustment also ignores historical data concerning such expenses. Staff's proposal is far below the level of legal expense for any recent year:[75]

Staff Proposal	$177,329
2004 Actual	$373,174
2005 Actual	$488,380
2006 Actual	$425,540
2007 Projected	$425,208

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[71] Id.
[72] Ex. UNSG-13 at 17-18; UNSG-14 at 9.
[73] Ex. UNSG-13 at 17; Tr. at 293.
[74] Tr. at 843.
[75] Table derived from Ex. UNSG-13 at 17-18 and UNSG-14 at 9.

UNS Gas also projects that its legal expenses will be "in the $400,000 range for the foreseeable future."[76] Staff's proposal is inconsistent with the Company's actual historic level of legal expense, the Company's projections of legal expense in future years, and the reality that the Company faces two new FERC rate cases. Staff's adjustment should therefore be rejected.

The record evidence clearly supports recovery of the actual test year legal expenses of $488,380. However, UNS Gas is willing to accept a lower, averaged figure of $430,777.[77] This level of legal expense clearly is recurring and should be included in rates. However, if there is any doubt or concern about the recurring nature of these expenses, there is a simple solution. The Commission could approve recovery of legal expenses related to FERC rate cases – which affect the cost of gas that UNS Gas must pay – through the PGA. If there are lower expenses in the future, which seems to be the concern of Staff and RUCO, then only the actual expenses will be recovered. This proposal makes sense, since other gas transportation costs are included in the PGA.

d. Rate Case Expense.

RUCO proposes to dramatically reduce rate case expense. RUCO's proposal is based on an analogy to the Southwest Gas Corporation ("Southwest Gas") rate case.[78] This analogy is severely flawed due to substantial accounting differences between UNS Gas and Southwest Gas'. The result of these differences is that rate case expense simply cannot be compared between these two companies.

The difference is that the costs of Southwest Gas' internal personnel and support services are built into its base rates, while UNS Gas must recover the equivalent costs through rate case expense.[79] It is thus no surprise that UNS Gas' rate case expense is higher, because UNS Gas' expense includes many items that Southwest Gas recovers though other expenses.

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[76] Ex. UNSG-14 at 9.
[77] Ex. UNSG-13 at 18.
[78] Ex. RUCO-3 at 25-26.
[79] Ex. UNSG-13 at 33-35.

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More specifically, Southwest Gas has various in-house experts, lawyers and other support or administrative personnel who participated in its rate case. Those in-house costs amount to overhead that is recovered in base rates rather than through rate case expense. Because Southwest Gas serves in three states, those overhead costs are allocated to each state using a "Massachusetts formula."[80] In contrast, UNS Gas does not have in-house legal or rate departments.[81] Instead, UNS Gas uses the rate and legal departments of Tucson Electric Power Company ("TEP").

When non-executive TEP employees work on UNS Gas activities, they record those tasks on their time sheets and those expenses are directly charged to UNS Gas.[82] This ensures that TEP customers do not subsidize UNS Gas operations.[83] RUCO's witness, Mr. Moore, agreed that it is important to avoid such cross-subsidies.[84] No party filed testimony challenging UNS Gas' cost allocation method.

Because RUCO failed to consider the different accounting methods used by UNS Gas and Southwest Gas, its attempt to compare figures from these two companies is not appropriate. Once the different accounting methods are considered, it is clear that UNS Gas customers benefit from the Company's method. If UNS Gas used the Massachusetts formula method used by Southwest Gas, its test year expenses would be $2.5 million higher.[85] RUCO's adjustment would unfairly penalize the Company for using an accounting method that saves UNS Gas customers money.

RUCO fails to note other important cost comparisons between UNS Gas and Southwest Gas. Southwest Gas' system-allocated labor costs amounted to 6.38 percent of operating expenses, while UNS Gas' were only 1.75 percent.[86] If UNS Gas had a comparable percentage, its operating costs would increase by nearly $1.8 million.[87] This is much more than the difference in rate case expense between the two companies. Once the whole picture is considered, UNS Gas

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[80] Ex. UNSG-13 at 33-35; Ex. UNSG-1 at 9-11.
[81] Id.; Tr. at 625.
[82] Ex. UNSG-13 at 33-35; Ex. UNSG-14 at 9-11; Tr. at 281, 887-88.
[83] Id.
[84] Tr. at 624.
[85] Ex. UNSG-14 at 10.
[86] Ex. UNSG-25 at subpart d.
[87] See id. for underlying data ($38,740,547 times 0.0638 is $2.47 million, less actual expense of $679,468 equals $1.79 million).

compares favorably. RUCO's attempt to look at one expense category in isolation, when that expense contains different elements due to different accounting methods, is deeply flawed and should be rejected.

Moreover, even if the rate case expense of the two companies could be directly compared, the two cases are different. For example, UNS Gas received more than twice as many data requests as Southwest Gas.[88]

Staff did not propose an adjustment to rate case expense in its direct testimony. In Surrebuttal Testimony, however, it adopted RUCO's adjustment using the same arguments as RUCO.[89] Staff's position should be rejected for the same reasons RUCO's should be rejected. Indeed, Staff's witness, Mr. Ralph Smith, testified that he was not familiar with Southwest Gas' accounting.[90] Thus, Staff did not add any additional support to RUCO's position.

However, while on the stand, Mr. Smith attempted to articulate a new justification for the disallowance.[91] Although the exact basis of Mr. Smith's on-the-fly justification is unclear, it seems to have something to do with the relationship between TEP's rate case expense and UNS Gas' rate case expense. Whatever Staff's new argument may be, it should not be considered because it was not included in pre-filed testimony. Staff, like the other parties, was ordered to pre-file its testimony. The Commission recently rejected a similar attempt by Staff to introduce a new argument at hearing, explaining "the timing of Staff's changed recommendation is problematic because it did not afford other parties an opportunity to explore fully the underlying basis of Staff's proposal."[92] The same is true here. Indeed, this example is even more problematic because Staff did not reveal its new argument on direct examination. Instead, Staff waited until re-direct and re-cross to introduce its new argument. As such, other parties were not afforded a fair opportunity to explore this new argument. Staff may consider exploring its "concerns" more fully in the rate case TEP is preparing to file.

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[88] Tr. at 632; Ex. UNSG-13 at 13-14.
[89] Ex. S-27 at 42-44.
[90] Tr. at 886-894.
[91] Tr. at 895-898.
[92] *Arizona-American Water Co. (Mohave),* Decision No. 69440 (May 1, 2007) at 15.

In summary, RUCO's comparison suffers from an "apples to oranges" problem because UNS Gas' rate case expense includes costs that Southwest Gas recovers in other ways. Moreover, if UNS Gas' allocated labor costs were similar (on a percentage basis) to Southwest Gas, the Company's operating expenses would be $1.8 million higher.[93] In ignoring this, RUCO considered only half the picture. Further, UNS Gas' direct allocation method actually saves UNS Gas ratepayers $2.5 million.[94] Once UNS Gas' accounting method is considered, its rate case expense is reasonable and should be approved.

e. Call Center Expenses.

UNS Gas uses TEP's call center to respond to customer calls. Some of the call center costs are allocated to UNS Gas. RUCO proposes that all of these costs be disallowed and replaced with much lower hypothetical costs based on regional offices used in a previous year. RUCO's proposal, which is not supported by Staff, is flawed in several respects. RUCO does not dispute that call volume doubled.[95] RUCO did not adjust its hypothetical costs to reflect this doubling of call volume.[96] Nor did RUCO calculate the cost of updating the old regional office system to be able to deal with the much higher call volumes.[97] RUCO's proposal is based on speculation that the doubling of call volume is due to fewer walk-in visits. But RUCO admits it has no evidence of a correlation between call volume and the number of walk-in visits.[98] In addition, RUCO acknowledges that new PGA surcharges during the test year may have been the source of many of the calls.[99] Further, the new call center provides longer hours and other enhancements. For example, it allows the Company to track wait times, which could not be done under the old, decentralized system.[100] RUCO's speculation does not provide sufficient support for this disallowance, and it should be rejected.

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[93] Ex. UNSG-25 at subpart d.
[94] Ex. UNSG-14 at 10.
[95] Tr. at 638.
[96] Tr. at 640.
[97] Tr. at 643.
[98] Tr. at 642.
[99] Tr. at 643.
[100] Tr. at 640-41.

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f. Small Expenses.

RUCO witness Mr. Moore suggests that a list of about 2,000 supposedly suspect expenses totaling $233,347 be disallowed. UNS Gas' general manager, Mr. Gary Smith, testified that most of these expenses "are directly related to safety, system integrity and operator training."[101] Mr. Smith then explained the necessity of various categories of expenses on Mr. Moore's list. For example, Mr. Smith explained that most of the expenses related to travel for "regulatory-mandated functions such as leak surveys, safety audits, and training" and other expenses included "participation in the annual-mandated Commission pipeline safety audit and required operator qualification training, welder qualification training, and emergency response testing."[102] Many of the remaining expenses are for "small tools that are necessary for maintaining the pipeline system."[103] Mr. Moore's Surrebuttal Testimony did not respond to Mr. Smith's explanation.[104] Instead, Mr. Moore attacked Mr. Dallas Dukes for suggesting that RUCO limit its audit to material items.[105] Mr. Dukes' comment is well-founded, as 90 percent of the challenged expenses are under $200 and 65 percent are under $50.[106] It is not reasonable to provide 2,000 specific responses when RUCO makes only a general objection to these expenses. Of the 2,000 expenses, RUCO provides a specific objection to only 5.[107] For the remaining 1,995 expenses, Mr. Smith provided a general explanation in response to RUCO's general objection. RUCO did not respond to or rebut Mr. Smith's explanation.

RUCO's demand for a specific explanation of the remaining 1,995 expenses is profoundly unreasonable. RUCO did not consider the cost of preparing such a response.[108] There are superior ways of examining small, non-material expenses. For example, RUCO could have reviewed a sample of the expenses, or it could have reviewed the Company's internal controls. RUCO did not

[101] Ex. UNSG-16 at 5-6.
[102] Id.
[103] Id.
[104] Ex. RUCO-4 at 12-13.
[105] Id.
[106] Tr. at 636.
[107] Ex. RUCO-4 at 13.
[108] Tr. at 636.

select those alternatives.[109] Instead it selected the most expensive, impractical method. And when the Company did not comply, RUCO recommended that each of those 1,995 expenses be disallowed, even though RUCO never made a specific objection to any of them.

Mr. Moore did provide a specific explanation of his concerns about five expenses. Those expenses total $12,254. To limit the areas of disagreement, UNS Gas will accept a disallowance in that amount. Indeed, UNS Gas agrees to a larger disallowance of $27,968 to address any concerns with these expenses.[110] The remaining expenses should be allowed for the reasons explained by Mr. Gary Smith, and because RUCO has not provided a specific explanation as to why any of them should be disallowed.

g. Performance Enhancement Program.

The Company's Performance Enhancement Program ("PEP") is a core component of its employees' compensation, and it promotes important goals such as cost containment and customer service. Such plans are standard practice at nearly four out of every five companies and are essential to attracting and retaining qualified employees[111]. Accordingly, the PEP is part of the cost of service, and there are no grounds for disallowing it.

Mr. Dukes testified that the PEP is "an integral part of the fair and reasonable compensation necessary to attract and retain employees."[112] He explained that average cash compensation was below that of comparable firms.[113] Thus, if the PEP were eliminated, base salaries would have to be increased in order for UNS Gas to attract and retain the necessary employees.[114] Further, he testified that similar programs are standard practice at most companies.[115]

The PEP has several advantages over increased base compensation. The PEP's goals include financial targets (30 percent), cost containment (30 percent) and customer service (40

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[109] Tr. at 637-38.
[110] Ex. UNSG-17 at 3.
[111] Id.
[112] Ex. UNSG-13 at 9.
[113] Id.
[114] Id.
[115] Id.

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percent).[116] The PEP therefore provides enhanced motivation for better performance as compared to increased base compensation. In addition, lower base pay results in lower expenses for vacation pay, sick pay, long-term disability, 401(k) matching, pension expense and other post-retirement benefits.[117]

There is therefore no doubt that the PEP is a legitimate part of the Company's cost of service. Staff does not dispute this. Nevertheless, Staff still proposes that one-half the PEP be disallowed because the plan "can provide benefits to both shareholders and ratepayers."[118] But nearly any expense can be claimed to benefit shareholders. Arizona law requires that all reasonable operating expenses be included in rates. *Tucson Electric Power, supra*; *Scates, supra.* The Commission must determine whether the expense is a reasonable operating expense rather than engaging in a vague "benefits" analysis. Staff says that the PEP expense "should be allocated equally to shareholders and ratepayers."[119] Whatever words Staff wants to use, its recommendation amounts to a disallowance. Because legitimate operating expenses cannot be disallowed, Staff's disallowance must be rejected.

RUCO's position is even more extreme. RUCO suggests that the entire PEP program be disallowed. During the test year, PEP payments were not made directly under the PEP but under a related special recognition award authorized by the Board of Directors.[120] RUCO seizes on this to argue that no expenses should be allowed. But the special award is clearly equivalent to the PEP payments.[121]

UNS Gas proposes an average of the costs from 2004 and 2005. RUCO objects, touting its "strict implementation of the Historical Test Year principle."[122] A strict test year approach would allow recovery of all of the test year special recognition award. UNS Gas would accept such an

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[116] Id. at 8.
[117] Id. at 9.
[118] Ex. S-27 at 29.
[119] Id.
[120] Ex. RUCO-3 at 16-17.
[121] Tr. at 228-32.
[122] Ex. RUCO-3 at 16-17.

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approach. RUCO's attempt to reject both the averaged PEP expense and the actual test year expense is inconsistent, which is unreasonable.

h. Officers' Long-Term Incentive Program.

This program is an integral part of the officer's total compensation program.[123] The arguments regarding this program are essentially identical to the PEP, and these costs should be allowed for the same reasons.

i. Supplemental Executive Retirement Plan.

Staff and RUCO both recommend that UNS Gas' Supplemental Executive Retirement Plan ("SERP") be completely disallowed. Staff and RUCO have not presented evidence that the SERP is an atypical cost for a utility, or that UNS Gas' overall executive compensation costs are unreasonable or out of line with industry practice. Both Staff and RUCO place great emphasis on the recent Southwest Gas decision. That decision disallowed expenses for Southwest Gas' SERP program.[124] However, neither Staff nor RUCO prepared a detailed comparison of the Southwest Gas SERP program and the UNS Gas SERP program. Moreover, this new Southwest Gas decision was issued after the test year. Prior to this new decision, the Commission had allowed SERP costs. In the previous Southwest Gas case, for example, the Commission allowed recovery of SERP costs.[125] This older decision was the only guidance available to UNS Gas during the test year about what expenses were acceptable. Had UNS Gas been notified that SERP costs would not be allowed, it could have restructured its executive compensation package to take that into account. It would not be fair to hold UNS Gas to this new, unexpected standard.

Again, no party has presented evidence that overall executive compensation costs are unreasonable. UNS Gas believes the Commission's earlier *Southwest Gas* ruling was correct in that it declined to dictate the details of executive compensation methods. Instead, that decision focused on whether the utility's "overall compensation package is excessive."[126]

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[123] Ex. UNSG-13 at 11.
[124] *Southwest Gas Corp.*, Decision No. 68487 (Feb. 23, 2006) at 18-19.
[125] *Southwest Gas Corp.*, Decision No. 64172 (Oct. 30, 2001) at 14-15.
[126] Id.

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Moreover, the SERP exists only to hold executives harmless from certain provisions of the Internal Revenue Code. That Code is a determination of what should be taxed, not a determination of the appropriate level of executive compensation. The Commission should not allow the Internal Revenue Code to dictate what compensation costs should be recovered.

j. Bad Debt Expense.

Staff and UNS Gas are basically in agreement as to bad debt expense. RUCO's proposal to disallow $100,000 is based on a mismatch and should be rejected. RUCO used the Company's historic uncollectible or write-off percentage and applied that to the adjusted test year revenues. In theory, that approach is acceptable. However, RUCO excluded the Griffith Plant and NSP revenues from test year revenue, but did not exclude those same items from the calculation of the write-off percentage.[127] RUCO's adjustment therefore creates a mismatch between revenues and the write-off percentage. Applying actual revenues to the actual write-off percentage would be appropriate. Applying adjusted revenues (excluding Griffith and NSP) to an adjusted write-off percentage (excluding Griffith and NSP) would also be appropriate. But mixing the two is inconsistent and a mismatch.[128] RUCO's disallowance should therefore be rejected.

k. Payroll Expense and Payroll Tax Expense.

In Rebuttal Testimony, UNS Gas corrected an error to its original payroll expense adjustment.[129] Staff and RUCO failed to pick up this correction. The corrected amount should be approved. A corresponding adjustment also should be made to payroll tax expense.[130]

l. Fleet Fuel Expense.

UNS Gas proposes an average fleet cost of fuel of $2.48 per gallon.[131] This reflects the historical average fuel costs of UNS Gas.[132] Staff proposes a lower adjustment based on state-wide average costs.[133] This proposal should be rejected because it does not reflect UNS Gas'

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[127] Ex. UNSG-13 at 24-25.
[128] Id.
[129] Id. at Ex. DJD-1, page 2.
[130] Id.
[131] Ex. UNSG-13 at 19.
[132] Id.
[133] Id.

actual costs.[134] It is not surprising that UNS Gas has slightly higher fuel costs because its service area is far from major urban centers like Phoenix and Tucson and is larger in scope (e.g., square miles covered within the service territory). RUCO's proposal to use an even lower cost of fuel does not reflect UNS Gas' known, current costs. Indeed, UNS Gas' proposal of $2.48 per gallon is far below current gas costs of over $3.00 per gallon.

m. Out-of-Period Expenses.

RUCO did locate some out-of-period invoices inadvertently included in test year expenses and proposes disallowing these expenses. However, RUCO fails to recognize that test year invoices of a nearly equivalent total amount were inadvertently excluded from test year expenses.[135] These mistakes essentially cancel each other out, so that no adjustment is necessary. If the out-of-test year invoices are excluded, the additional test year invoices should be added to test year expenses.[136]

n. Postage Expenses.

Staff's and RUCO's postage expense calculations should be rejected due to several errors. Staff and RUCO understate test year postage expense because they fail to account for a prior period adjustment of $58,498.[137] In addition, Staff and RUCO fail to recognize that postage expense is affected by a number of factors outside of simple customer numbers, such as the number of required mailings and the weight of mailings.[138] The Company therefore proposed a two-year average of $529,380. The Company's proposal is less than its actual 2006 postage expense of $553,648[139], and the 2006 expense does not reflect the known and measurable change in postage rates effective May 14, 2007.

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[134] Id.
[135] Id. at 14.
[136] Id.
[137] Id. at 19-21, 28.
[138] Id.
[139] Id.

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o. Industry Association Dues.

UNS Gas accepts RUCO's adjustment to industry association dues. RUCO appropriately excludes portions relating to lobbying and marketing. RUCO's adjustment is consistent with the American Gas Association's ("AGA") 2007 budget for lobbying and marketing.[140] In contrast, Staff's adjustment is based on an antiquated 2001 report which used 1999 data.[141] Moreover, Staff's adjustment fails to consider that some AGA activities are not funded by dues.[142]

p. Training Expenses.

RUCO suggests disallowing MARC training expenses. While any particular training event may be non-recurring, training costs in total are recurring.[143] Moreover, the Company's productivity gains cannot entirely offset the need for new employees to help serve its rapidly growing customer base. As such, the Company expects training costs to continue to increase for the foreseeable future, including those required by a new regulatory requirement imposed after the test year.[144] If anything, test year training expenses understate future expense levels. As such, they certainly should not be decreased.

q. Miscellaneous Expenses.

A number of expenses are directly tied to rate base issues. Examples include depreciation expense, GIS amortization expense, property tax expense and CWIP-related expenses. These expenses should reflect the correct rate base level of the corresponding rate base accounts as discussed in the rate base portion of this brief. Likewise, other expenses (such as income taxes) are tied to other calculations and should reflect the positions taken herein.

r. Undisputed Expenses.

The Commission should approve the following uncontested expense adjustments, as shown on Exhibit Attachment 1: (1) Griffith Plant Operations; (2) Purchased Gas Cost and Gas Cost Revenue; (3) NSP Revenue and Gas Cost; (4) Post Retirement Medical; (5) Worker's

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[140] Id at 18.
[141] Ex. S-25 at Ex. RCS-2 (2001 NARUC Committee Report on AGA for period ending December 31, 1999).
[142] Id. (expenses total 107 percent because some expenses "not funded by dues").
[143] Ex. UNSG-17 at 4.
[144] Id.

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Compensation; (6) Interest on Customer Deposits; (7) Year End Accruals; (8) Advertising & Donations; (9) CARES; (10) Gain on Sale of Prescott Property; (11) Corporate Cost Allocations; (12) Depreciation annualization; (13) Emergency Bill Assistance; and (14) Cancellation of RUCO Operation Income Adjustment No. 20.

C. UNS Gas' Proposed Cost of Capital is Reasonable.

The Company requests a weighted average cost of capital of 8.80 percent. This is based on a 6.6 percent cost of debt, an 11.0 percent cost of common equity capital, and a capital structure consisting of 50 percent long-term debt and 50 percent common equity. The rate of return on fair value rate base is 7.43 percent. Both Staff and RUCO agree with UNS Gas' cost of debt but have recommended a much lower cost of equity. RUCO, but not Staff, has agreed with the Company's proposed capital structure. UNS Gas' proposed cost of capital is critical to attract necessary capital to meet the growth it is facing in its service area and should be adopted by the Commission.

1. Capital Structure.

UNS Gas proposes a capital structure of 50 percent debt and 50 percent equity. This capital structure is based on the projected capital structure for the time period in which the rates will be in effect.[145] As the Commission stated "cost of capital is forward-looking in nature [so] the most current capital structure available should be used when determining a company's cost of capital, as it will more closely represent the company's true level of financial risk."[146] Here, UNS Gas' projected capital structure is the most current information available, and it best reflects the forward-looking nature of the cost of capital.

UNS Gas' projection is consistent with the clear trend in the Company's capital structure. UNS Gas had just 33 percent equity upon its inception in 2003.[147] By the end of the test year, UNS Gas had increased its equity ratio to 45 percent.[148] This is the result of an aggressive program to increase UNS Gas' equity level. UNS Gas has retained all of its earnings; it has never

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[145] Tr. at 964.
[146] *Black Mountain Gas Co.,* Decision No. 64727 (April 17, 2002) at 12.
[147] Ex. UNSG-27 at 9.
[148] Id.

paid a cent in dividends.[149] In addition, its shareholder injected $16 million of new equity into UNS Gas. The Commission should recognize and encourage such strengthening of the Company

While the Company's equity ratio has improved, other key metrics have deteriorated. This includes weak earnings and cash flow.[150] Increased equity helps offset these other weaknesses, because lenders are more willing to lend to a well-capitalized firm.[151]

RUCO supports UNS Gas' proposed capital structure.[152] RUCO's witness, Mr. William Rigsby, testified that UNS Gas' proposed 50 / 50 capital structure is in line with the capital structures of his sample group of companies.[153]

Staff's capital structure should be rejected because it does not recognize the forward-looking nature of cost of capital. Staff's capital structure would be out of date by the time rates go into effect. Moreover, Staff's proposal does not recognize the results of the Company's concerted efforts to improve its capital structure and would not offset the negative effects of weak earnings and cash flow.

The Commission has used hypothetical or projected capital structures in many cases in the past. For example, the Commission used a hypothetical capital structure in the recent Southwest Gas rate case.[154] In the last month, the Commission approved another such structure, rejecting arguments by Staff that are similar to its position in this case.[155] Hypothetical or projected capital structures help remedy financial weakness. Further, such structures may be especially appropriate when the utility is making "a concerted effort to improve its equity ratio in the future,"[156] as UNS Gas is doing here. Lastly, a projected capital structure properly recognizes the forward-looking nature of the cost of capital.

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[149] Id.
[150] Ex. UNSG-27 at 10.
[151] Id.
[152] Tr. at 999.
[153] Id.
[154] *Southwest Gas Corp.*, Decision No. 68487 (Feb. 23, 2006).
[155] *Arizona-American Water Co. (Mohave),* Decision No. 69440 (May 1, 2007) at 13-14.
[156] Id. at 14.

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2. Cost of Debt.

UNS Gas' proposed cost of debt is 6.60 percent.[157] No party disputed the cost of debt at the hearing. Accordingly, this cost should be approved by the Commission.

3. Cost of Equity.

There are three main disputes concerning cost of equity in this case. First, RUCO's Discounted Cash Flow ("DCF") analysis is inconsistent with UNS Gas' and Staff's DCF studies, and RUCO uses methods that have been rejected by the Commission in the past. Second, Staff's and RUCO's use of geometric mean returns in their application of the Capital Asset Pricing Model ("CAPM") is contrary to both academic and financial literature. Third, RUCO and Staff base their cost of equity for UNS Gas on the cost of equity they calculate for their sample group. But they disregard the fact that UNS Gas is substantially more risky than the sample group companies because it is much smaller, faces extreme growth, has regulatory lag, and has never paid a dividend. UNS Gas is very different from any of the sample companies, and it defies logic to say that it has the same cost of equity as those companies.

a. RUCO's Discounted Cash Flow Study is unsound.

UNS Gas and Staff reach nearly identical results from their DCF studies.[158] RUCO's results, however, are far different. RUCO places too much reliance on near-term analyst growth forecasts. As the Commission has noted, "exclusive reliance on analyst forecasts" is erroneous.[159] RUCO supports its use of analyst growth forecasts by pointing to FERC's DCF method. RUCO's witness, Mr. Rigsby, candidly admitted that he got this idea from another cost of capital witness, Dr. Zepp.[160] Mr. Rigsby also admitted that the Commission rejected Dr. Zepp's FERC-based approach in two recent cases.[161] All Mr. Rigsby could say is that "the Commission has been known to change its mind" in the past.[162]

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[157] Ex. UNSG-27 at 24.
[158] Tr. at 1015.
[159] *Arizona Water Company (Eastern Group)*, Decision No. 66849 (March 19, 2004) at 22.
[160] Tr. at 1001.
[161] Tr. at 1002-1003; see also Ex. UNSG-33 (*Chaparral City Water Co.*, Decision No. 68176) at 23- 26; *Arizona Water Co. (Western Group)*, Decision No. 68302 (Nov. 14, 2005) at 37.
[162] Tr. at 1008.

Moreover, Mr. Rigsby only uses a single-stage DCF model. Because of this, Mr. Rigsby's approach assumes that wide differences between company growth rates will continue forever.[163] It is more realistic to expect such growth rates to converge towards the industry average.[164] In addition, when adjusted for inflation, Mr. Rigsby assumes perpetual growth rates much lower than projected or historic long-term growth rates in the U.S. economy.[165] Indeed, long-term growth in the U.S. economy has been remarkably consistent.[166] By contrast, UNS Gas used a multi-stage DCF model while Staff used both a multi-stage model and a single-stage model. In recent years, Staff has used both single-stage and multi-stage DCF models.[167] The Commission has approved such Staff recommendations in numerous recent orders.[168]

RUCO's DCF model relies too heavily on analyst forecasts, an approach rejected by the Commission in the past. Those analyst forecasts project widely varying growth rates for different companies. RUCO assumes that those divergent growth rates will continue forever. It is much more logical to assume that growth rates for those companies eventually will converge toward historical growth rates for the gas industry or the economy as a whole. RUCO also failed to use the multi-stage DCF model that the Commission has approved on many occasions. For these reasons, RUCO's DCF model should be rejected.

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b. Use of geometric means in the Capital Asset Pricing Model is without merit.

Staff and RUCO both use geometric means returns in calculating the market risk premium in their CAPM models. The use of geometric means is contrary to well-established financial theory, sound financial practice, and basic mathematics. Staff's witness, Mr. David Parcell, did

163 Ex. UNSG-28 at 4.
164 Id.
165 Id.
166 Tr. at 993.
167 Tr. at 1009.
168 *See e.g., Arizona-American Water Co. (Mohave)*, Decision No. 69440 (May 1, 2007) at 18-19; *Arizona-American Water Co. (Paradise Valley),* Decision No. 68858 (July 28, 2006) at 25-29; *Arizona Water Co. (Western Group)*, Decision No. 68302 (Nov. 14, 2005) at 35-40; *Chaparral City Water Co.*, Decision No. 68176 (Sept. 30, 2005) at 21-26; *Arizona-American Water Co.*, Decision No. 67093 (June 30, 2004) at 25-31; *Arizona Water Co. (Eastern Group)*, Decision No. 66849 (March 19, 2004) at 22.

not dispute that the overwhelming academic consensus supports the use of arithmetic means for this purpose. Instead, Mr. Parcell implies that the overwhelming academic consensus is unrealistic, contending that "the cost of capital determination is not an academic exercise made in some laboratory or university classroom."[169] However, the CAPM model was developed by academics, and it makes no sense to disregard academic views of how it should be used.

Real world financial professionals also reject the use of geometric means. Mr. Parcell testified that he uses the Ibbotson Yearbook, as do the other witnesses in this case, and that "a lot of copies are sold" of that publication.[170] Yet this widely-used resource specifically rejects the use of geometric means, expressly stating that "[f]or use as the expected equity risk premium in... the CAPM... the arithmetic mean... is the relevant number."[171]

The use of geometric means also runs counter to basic mathematics. An arithmetic mean is best suited for forming expectations of future returns.[172] In contrast, the geometric mean is best suited for stating historical returns.[173] This basic concept is shown by Mr. Kentton Grant's mathematical example.[174] The Commission has recognized that cost of capital is a forward looking endeavor. It makes no sense to use a backward looking statistic when estimating expectations of future returns.

Mr. Parcell did not attempt to defend the use of geometric means by referring to academic articles, the practices of real world financial professionals, or basic principles of mathematics.[175] Instead, Mr. Parcell points out that both types of means are available, and therefore "presumably" both types are used.[176] Mr. Parcell admits there is no empirical data to support his speculation on this point.[177] The Commission should not rely on such unsupported conjecture. Mr. Parcell's speculation amounts to saying "if it's out there, people will use it." This leads to absurd results.

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169 Ex. S-37 at 4.
170 Tr. at 1020-21.
171 Ex. UNSG-28 at 18-19.
172 Ex. UNSG-29 at 17-19.
173 Id.
174 Id.
175 Ex. S-36 at 30; Ex. S-37 at 3-4.
176 Id.; Tr. at 1023-24.
177 Tr. at 1024.

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For example, Mr. Parcell contended that investors may look to the result of a Suns basketball game to make their investment decisions.[178]

Mr. Parcell agreed that the CAPM model assumes the existence of a rational and informed investor.[179] It defies common sense to say that a rational and informed investor will base investment decisions on sporting events. Instead, an informed investor would understand basic mathematics, would know that both academics and financial professionals reject the use of geometric means in the CAPM model and would surely use that knowledge to select the arithmetic mean.

The use of the arithmetic mean is supported by academics and financial professionals, as well as by basic mathematics. Staff's speculation that rational investors will disregard these facts and knowingly use the inappropriate geometric mean is without support and should be rejected. Accordingly, the Commission should support the use of the arithmetic mean return in applying the CAPM model.

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c. Staff's and RUCO's Cost of Equity estimates are unreasonably low.

As shown above, Staff's and RUCO's return on equity ("ROE") estimates are not appropriate because they are based on clear technical errors. Even if that were not so, Staff's and RUCO's results fail a basic test of reasonableness. The ROEs proposed by Staff (10 percent) and RUCO (9.64 percent) fall far below those authorized by other state commissions. For example, Staff Exhibit 34 shows that Staff's ROE is 45 basis points below the ROEs approved in 2006. Staff's ROE is even further below the ROEs from previous years.

Therefore, if UNS Gas were an average gas utility company, the ROEs proposed by Staff and RUCO would be far too low. But UNS Gas is not an average gas utility - it faces higher risks in several areas. It is much smaller than the utilities in the sample group in this case.[180] It is growing far faster than those companies – faster even than other utilities in Arizona, the fastest

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[178] Tr. at 1021-22.
[179] Tr. at 1021.
[180] Tr. at 1020.

growing state in the nation.[181] UNS Gas is not just adding new customers, its investment per customer is also growing at a high rate.[182] In addition, as noted previously, UNS Gas has never paid a cent in dividends.[183] Finally, while most companies in the sample group have de-coupling mechanisms, UNS Gas does not.[184]

UNS Gas is therefore more risky than the sample group. As Mr. Parcell testified, a sample group should have "similar risk and therefore a similar expected cost of capital to the subject company."[185] Because UNS Gas is more risky than the companies in the sample group, it has a higher cost of equity. UNS Gas recognized this by selecting an ROE at the upper end of the range of results of the sample companies. In contrast, Staff and RUCO used the average results for the sample group companies, thereby failing to reflect UNS Gas' higher risk.

Although Staff and RUCO prefer to treat UNS Gas as an average gas utility, they did little to rebut the Company's showing that it is more risky, with the exception of Mr. Parcell's suggestion that "growth is a positive factor for the Company."[186] This vague statement fails to consider the actual challenges imposed by growth on UNS Gas. In particular, the explosive growth in UNS Gas' service territory "requires substantial capital investment, currently at a level far exceeding the Company's internal cash flow."[187] This extra capital investment "creates additional fixed costs that UNS Gas must bear, including interest expenses, depreciation expense and property taxes."[188] Thus, the Company's earnings and cash flow are negatively impacted by growth.[189] Staff and RUCO have not rebutted these specific points.

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[181] Ex. UNSG-29 at Ex. KCG-15; Tr. at 920, 1004-5, 1020.
[182] Id.
[183] Tr. at 939.
[184] Tr. at 932; Ex. UNSG-37.
[185] Tr. at 1019; Ex. UNSG-34.
[186] Tr. at 1020.
[187] Ex. UNSG-28 at 9-10.
[188] Id.
[189] Id.

D. UNS Gas' Depreciation Rates Should be Approved.

The Company submitted a depreciation study as part of its rate case application. Neither Staff nor RUCO opposed any element of that study. UNS Gas requests that the Commission approve the depreciation rates set forth in that study.

E. The Commission Should Consider the Impact of the *Chaparral City* Ruling.

UNS Gas has raised the *Chaparral City* decision to preserve the issue in this docket while it is being resolved on remand from the court. However, the Commission's position in response to *Chaparral City* in this case is as flawed as the position rejected by the court.

1. The Commission should abandon the discredited "backing-in" method.

a. Staff used the unlawful backing-in method.

The witnesses for UNS Gas and Staff agree on at least one thing: that the Commission should comply with the Court of Appeals ruling involving the Chaparral City Water Company.[190] As Staff's witness, Mr. Parcell, explained, the *Chaparral City* decision requires the Commission to "consider the fair value of a utility's assets in setting rates."[191]

Unfortunately, Staff never explains how its approach differs from the now-discredited approach used in *Chaparral City*. That is not surprising, because there is no material difference between Staff's approach here and the Commission's approach in *Chaparral City*. Staff's approach is to "re-cast" its cost of capital as a "fair value cost of capital."[192] In other words, Staff "lowered the overall ROR applied to fair value rate base in order to achieve the same level of operating income calculated using Mr. Parcell's cost of capital and Staff's original cost rate base."[193]

In *Chaparral City*, the Commission adopted Staff's approach of determining rates by multiplying the original cost rate base by the cost of capital.[194] Only then did Staff calculate the

[190] Ex. UNSG-28 at 28; UNSG-29 at 12-13; Ex. S-37 at 7-9.
[191] Ex. S-37 at 7.
[192] Ex. S-37 at 9.
[193] Ex. UNSG-28 at 28.
[194] Ex. UNSG-33 (Decision No. 68179) at 26-28.

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"fair value rate of return."[195] This approach is often called the "backing-in" method because the revenue requirement is determined using the cost of capital and the original cost rate base; the fair value numbers are simply a meaningless exercise determined after the fact.

Staff has clearly used this same discredited "backing-in" method here. The uncontraverted evidence is that Staff's approach in this case "is mathematically equivalent to the approach previously used by Staff and expressly rejected by the Court of Appeals in the *Chaparral City* case."[196] The Commission should reject this unlawful, discredited method.

b. Staff's approach ignores fair value.

Staff witness Mr. Parcell candidly admitted that under his approach, fair value has no impact on rates. Under his approach, otherwise identical companies will have the same rates, even if their fair value rate base differs.[197] Mr. Parcell testified that, all other factors remaining equal, the following three hypothetical companies have the same return dollar requirement:[198]

Company	Original Cost Rate Base	Fair Value Rate Base	Return Dollar Requirement
1	$10 million	$ 10 million	Same for all three
2	$10 million	$ 20 million	Same for all three
3	$10 million	$100 million	Same for all three

Under Staff's approach, fair value simply has no impact on rates.

c. The Commission must use fair value.

The Arizona Constitution contains a clear command: "The Corporation Commission shall… ascertain the fair value of the property within the State of every public service corporation doing business therein"[199] Fair value is not optional. As the Arizona Supreme Court recently

[195] Id.
[196] Ex. UNSG-29 at 13.
[197] Tr. at 1027.
[198] Tr. at 1024-1027.
[199] Arizona Constitution, Article 15, § 14.

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held, the fair value section "is an imperative... [t]he constitutional provision in question does not... say or imply anything about the existence of discretion in the commission." *U.S. West Communications, Inc. v. Arizona Corp. Comm'n*, 201 Ariz. 242, 246, 34 P.3d 351, 355 (2001).

Not only is the Commission required to find fair value, but it must also use that fair value finding in ratemaking. *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 151, 294 P.2d 378, 382 (1956); *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 533-34, 578 P.2d 612, 614-15 (App. 1979). Therefore, the Court of Appeals ruled that the Constitution requires "utilization of the fair-value finding" in setting rates. *Phelps Dodge Corp. v. Arizona Electric Power Co-op*, 207 Ariz. 95, ¶ 38, 83 P.3d 573, 586 (App. 2004).

As shown above, under Staff's approach, fair value has no impact on rates. Although Staff calculates a "fair value rate of return," this calculation can be completed only after the revenue requirement is determined through the "backing-in" method. This after-the-fact calculation is simply a meaningless exercise. The constitutional requirement to use fair value cannot be satisfied when fair value is used merely as window dressing. Staff's approach therefore must be rejected.

RUCO suggests that that the Commission ignore the *Chaparral City* decision for two reasons: (i) the issue is "premature" because the Commission obtained an extension of time to seek review in the Arizona Supreme Court; and (ii) the decision is an unpublished opinion.[200] The additional time granted by the Court has now expired, and the Commission did not file a petition for review.[201] Thus, RUCO's first argument is no longer relevant. It is true that the *Chaparral City* decision is unpublished, and while this means that the decision should not be cited, the principle behind the decision remains valid. That principle is that the Commission must use fair value in setting rates. Staff's and UNS Gas' witnesses testified in support of this principle. Moreover, the holdings of many published cases adopt this principle, as shown above. Contrary to RUCO's suggestion, this issue cannot be ignored.

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[200] Ex. RUCO-6 at 4-5.

[201] The Commission may take official notice of the Court of Appeals docket sheets, which are available on-line. See A.A.C. R14-3-109.T.5.

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Staff attempts to defend its approach by arguing that the Commission should allow investors "a return on the capital they provided the utility" – or, in other words, a "return on their invested capital."[202] Staff then argues that any difference between the original cost and the fair value should be disregarded or assigned a zero cost "because there are no investor-supplied funds supporting the difference between fair value rate base and original cost rate base."[203] Staff's focus on the value of invested capital is called the "prudent investment theory." *See Simms*, 80 Ariz. at 151, 294 P.2d at 382. Whatever the merits of this theory, under the Arizona Constitution, the Commission is forbidden to use it. *Id.*; *Consolidated Water Utilities, Ltd. v. Arizona Corp. Comm'n*, 178 Ariz. 478, 141, 875 P.2d 137, 482 (App. 1994); *City of Tucson v. Citizens Utilities Water Co.*, 17 Ariz. App. 477, 482, 498 P.2d 551, 556 (1972). The ban on the use of the prudent investment theory has been made very clear by the Arizona Supreme Court: "[the] Commission cannot be guided by the prudent investment theory.... The amount invested is immaterial." *Arizona Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 203, 335 P.2d 412, 415 (1959). As the court explained, "under the law of fair value a utility is not entitled to a fair return on its investment; it is entitled to a fair return on the fair value of its properties devoted to the public use, no more and no less." *Id.*

2. UNS Gas' approach is the only lawful approach supported by the record.

All parties, including UNS Gas, have struggled with how to address the renewed emphasis on fair value. Because this issue arose after the application was filed, UNS Gas has agreed that the rate increase in this case should be no greater than the increase proposed in its application. UNS Gas addressed the fair value issue by proposing to use the weighted average cost of capital as the rate of return for fair value rate base.[204] This is not the only possible approach. It is, however, is the only approach presented in this case that complies with the Arizona Constitution.

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[202] Ex. S-37 at 8-9.
[203] Tr. at 1016.
[204] Ex. UNSG-28 at 28; Ex. UNSG-29 at 12-13.

Staff and RUCO continue to use the discredited "backing-in" approach. That approach does not use fair value, and it therefore does not comply with the Arizona Constitution. Moreover, the rationale offered by Staff, the prudent investment theory, has been specifically and repeatedly rejected by the courts.

It is possible that other constitutionally permissible methods may be developed in future cases. For now though, UNS Gas' approach is the only available choice in this case.

II. UNS GAS' PROPOSED RATE DESIGN IS REASONABLE.

The Company's rate design proposes to move a portion of costs currently collected through the volumetric charge to a fixed charge. Under UNS Gas' current rates, high-usage customers are paying a far greater share of the Company's fixed costs through volumetric charges on their monthly bills.

UNS Gas proposes increasing the monthly customer charge from \$7 to \$20 during the months of April through November, and to \$11 from December through March, resulting in an average monthly charge of \$17. The Company further proposes dropping the commodity, or volumetric, rate from \$0.3004 to \$0.1862 per therm. Under this proposal, a residential customer using 100 therms in the winter would see a net decrease in his/her bill from \$37.04 to \$29.62. A residential customer using 20 therms in the winter would see an increase from \$13.01 to \$14.72. In the summer, a residential customer using 100 therms would experience an increase from \$37.04 to \$38.62, while a customer using 20 therms would see an increase from \$13.01 to \$23.72.[205] Under UNS Gas' rate design, the average customer will experience approximately a 7 percent increase in rates over the course of a year.

UNS Gas' proposed rate design is intended to mitigate significant cross-subsidization of warm weather customers by cold weather customers and to better match non-volumetric revenues to fixed costs. Presently, UNS Gas incurs \$26 per month in fixed costs to serve a customer. The monthly customer charge, though, is just \$7. The remaining fixed costs are covered by a volumetric per-therm charge. As a result, a residential customer in Flagstaff pays almost twice as

[205] See Ex. UNSG-9 (Schedule H-4, Page 1 of 6).

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much for the Company's fixed costs as a residential customer in Lake Havasu City.[206] UNS Gas' proposed rate design is more equitable and represents better policy in the new environment of higher gas commodity costs.

UNS Gas' proposed rate design recognizes that most of the Company's distribution expenses are fixed costs.[207] The Company incurs these fixed costs regardless of how much gas customers consume. Mr. Erdwurm testified that UNS Gas' current rate design only collects approximately 25 percent of fixed distribution costs through the monthly customer charge.[208] This is inadequate from a financial perspective and inequitable in light of the cross-subsidies that result. Mr. Grant's testimony regarding the June 2006 Moody's Investors Service Report further highlights this problem with the traditional gas utility rate design. Specifically, that report notes that "As the fixed charges appear year in and year out regardless of gas usage, the volumetric approach to cost recovery for operating a gas distribution system is a faulty equation which needs to be rectified in ratemaking."[209] Further, the American Gas Association report "Natural Gas Rate Round-Up" notes that gas utilities are "in a fixed-cost business," and that a gas utility's profits and earnings will decline if customers use less gas under a traditional volumetric rate design.[210] These reports support the adoption of higher fixed cost recovery through fixed charges and decoupling mechanisms. It is time to address this inequity by raising the percentage of fixed costs recovered through the monthly customer charge, which will also reduce the subsidy cold climate customers provide to warm climate customers. This is what the Company proposes and what the evidence supports in this case.

The rate designs proposed by Staff and RUCO fail to address the cross-subsidy or matching problems to any material degree. Both Staff and RUCO assert "gradualism" and "rate shock" in response to proposed changes to the monthly customer charge without addressing the more moderate, gradual scale of the overall increase. Neither Staff nor RUCO offer any

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[206] Ex. UNSG-18 at 8 and Ex. TLV-1 thereto.
[207] Ex. UNSG-19 at 9.
[208] Tr. at 445.
[209] Ex. UNSG-29 at 23:14-16 and Ex. KCG-18 thereto (Moody's Investor Service Special Comment, June 2006 at 4).
[210] Ex. UNSG-37 at 2.

justification for the substantial level of cross-subsidization that will result from their rate designs. They also cannot justify their failure to match non-volumetric revenues to fixed charges. Finally, their complaint that a higher customer charge reduces customers' incentive to conserve fails to recognize the impact of the remaining per-therm gas commodity charge, which will remain high enough (60 to 70 cents per therm) to make conservation worthwhile. After all, the gas commodity charge is the largest and most visible component of the total volumetric rate, representing 60-70 cents per therm, which is two-thirds of total volumetric rate of approximately 90 cents per therm (30 cents volumetric margin and 60 cents commodity).

A. UNS Gas' Proposed Monthly Customer Charge Will Better Match Non-Volumetric Revenue to Fixed Costs.

UNS Gas' current monthly residential customer charge is $7. The actual cost of providing service to residential customers, excluding the cost of natural gas itself, is approximately $26.[211] Both Staff and RUCO agree that the current monthly charge covers just over one fourth of the Company's fixed costs.[212]

The Company proposes increasing the monthly customer charge from $7 to an average of $17 per month, an amount that would cover approximately 60 percent of the fixed costs of serving an individual residential customer.[213] At the same time, UNS Gas would reduce its volumetric margin charge from approximately 30 cents per therm to 18 cents per therm to pare back the usage-based recovery of fixed costs.[214] As set forth in Schedule H-4, these changes would result in an overall rate increase of approximately 7 percent (and less than that in certain circumstances). Further, the Company's rate design hardly guarantees revenue recovery. A significant portion of the fixed cost recovery would remain subject to volumetric charges,[215] and these costs will continue to increase.[216]

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[211] See UNSG-18 at 9; Ex. UNSG-19 at 12.
[212] See Ex. S-27 at Ex. RCS-S1R; Ex. RUCO-5 at 28; Tr. at 700, 822.
[213] Tr. at 512.
[214] See Ex. UNSG-9 (Schedule H-3).
[215] Ex. UNSG-19 at 12.
[216] Ex. UNSG-19 at 14.

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In an effort to mitigate the impact of winter gas bills, UNS Gas proposed two seasonal tiers for the monthly customer charge: $11 in the winter and $20 in the summer. This structure would provide a measure of bill levelization for all customers, making it easier to budget for monthly gas bills.[217] Given that Staff does not support this proposal because there is no cost basis for seasonal customer charges,[218] the Company would accept a year-round monthly customer charge at $17.

Staff and RUCO agree that an increased monthly customer charge is appropriate, but they disagree about the amount. Staff proposes an increase to $8.50 per month, while RUCO would limit the increase to $8.13 per month. Unfortunately, even Staff's proposal of $8.50 per month would recover just 30 percent of the Company's fixed costs through the customer charge, an increase of only 3 to 5 percent over the current level.[219] As a result, these proposals run directly contrary to the concepts of cost-based rates and revenue stability and should be rejected.

Moreover, the testimony of Staff's own witnesses suggests a charge much higher than $8.50 per month is appropriate. First, Staff's witness, Mr. Smith, agreed the Company should move toward cost-based rates.[220] He also indicated that, in his opinion, recovering 50 percent of the Company's fixed costs through the monthly customer charge could be reasonable.[221] That would amount to a monthly customer charge of $13.00. Mr. Ruback asserted that only direct customer costs, such as billing and meter reading, should be the basis for the monthly customer charge.[222] Even if one were to accept Mr. Ruback's theory, the monthly customer charge should be at least $11.88.[223] Mr. Ruback also acknowledged, though, that gas distribution costs are indeed fixed costs that currently are recovered mainly through volumetric charges.[224]

Neither Staff nor RUCO support a customer charge that realistically attempts to match costs to the cost causation or revenues to expenses. Given that $26 is the actual average monthly

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[217] Ex. UNSG-18 at 10; Tr. at 452.
[218] Tr. at 792.
[219] Tr. at 822.
[220] Tr. at 824.
[221] Id.
[222] Tr. at 792; see also Ex. S-24 at Exhibit SWR-2.
[223] Id.
[224] Ex. S-24 at 4-5.

fixed cost per residential customer, UNS Gas' proposal to recover an average of $17 through the monthly customer charge is reasonable. The average increase of $10 from the current charge is not drastic, will not result in rate shock and does not violate "gradualism," particularly given the proposed reduction in the volumetric charge and the overall rate increase of 7 percent. In sum, the Company's proposed rates have a sound cost basis and would better match revenue to costs per class than the Company's current rates, which recover approximately three quarters of its fixed costs through volumetric rates.[225]

B. The Company's Proposed Rate Design Will Reduce Existing Cross-Subsidies.

It is undisputed that cold weather customers subsidize those living in warmer climates, often to a substantial degree.[226] Currently, the average Flagstaff customer pays $133 more in annual margin than customers in Lake Havasu City for the same fixed costs.[227] Moreover, the cross-subsidy is difficult for cold weather customers to avoid (through reduced usage) because they rely on natural gas to heat their homes and for other inelastic needs. The changes proposed by UNS Gas would ease this disparity. Under the Company's recommended rates, an average residential customer in Flagstaff would pay an annual margin of $333, while the average Lake Havasu customer would pay $250.[228] Although the Flagstaff customer still would pay $83 more for the same fixed costs, the annual cross-subsidy would be reduced by $50 – a significant change. The Company's proposal better matches revenues to the actual costs of providing service.[229] By gradually moving customers toward footing their actual costs, the proposal comports with the view of RUCO and Staff that reducing cross-subsidies and promoting cost-based rates was appropriate.[230] In fact, some customers living in cold climates could experience a rate decrease under the Company's proposed rates as a result of the reduced cross-subsidy.[231]

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[225] Ex. UNSG-20 at 7:.
[226] Ex. UNSG-18 at 8 and Ex. TLV-1 thereto; see Tr. at 704.
[227] Ex. UNSG-19 at 10.
[228] Ex. UNSG-18 at Ex. TLV-1.
[229] Ex. UNSG-18 at 9.
[230] See Tr. at 704, 824.
[231] See Ex. UNSG-9 (Schedule H-4).

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The rate designs proposed by Staff and RUCO move so slowly toward their stated goals that one might question if they are actually standing still. If consumers in Flagstaff, Prescott and other cold weather communities were aware of the degree to which they were subsidizing gas service for their peers in warmer climates, they would no doubt demand more exigent action. Neither Staff nor RUCO dispute that their proposals would continue to allow a substantial portion of fixed costs to be recovered through volumetric rates, and therefore be borne by those who use more gas.[232]

C. The Company's Proposed Rate Design Does Not Violate "Gradualism" or Result in Rate Shock.

Although Staff and RUCO acknowledge that UNS Gas' current rates are not cost-based and result in substantial cross-subsidies among residential customers, both parties reject the Company's progressive rate design on the grounds of rate shock and gradualism. However, their opposition focuses solely on the monthly customer charge without taking into account the overall rate design and the cost of the gas itself. In fact, as set forth in Schedule H-4, the rate increase experienced by the average residential customer will be approximately 7 percent (or less in some circumstances). There will not be rate shock with such a modest increase. Moreover, the preference for gradualism is, in fact, satisfied in this case. UNS Gas is not proposing to raise its monthly charge high enough to cover 100 percent of its fixed costs. Rather, its proposed monthly charge will increase the portion of fixed costs covered by the monthly charge from 26 percent to 60 percent. Given the relatively high cost of the gas commodity itself compared to the Company's fixed costs, UNS Gas can move toward cost-based rates more aggressively without sacrificing gradualism.

Moreover, gradualism and rate shock must be balanced against other important rate design concepts, including revenue stability and matching principles. In this case, given the overall rate impact of UNS Gas' rate design, concerns about rate shock and gradualism have been managed appropriately.

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[232] Ex. UNSG-19 at 10-11.

D. UNS Gas' Rate Design Proposal Does Not Eliminate the Incentive to Conserve.

Staff's and RUCO's contention that the Company's proposed rate design reduces the incentive to conserve ignores the significance of the remaining volumetric charges – including the cost of natural gas itself. While the Company has proposed reducing the volumetric margin charge from $0.3004 per therm to $0.1862 per therm,[233] the cost of gas passed through the PGA recently has ranged between 60 and 70 cents per therm.[234] Therefore, under the Company's proposal, the overall volumetric charge (assuming a 60 cent per therm PGA charge) will drop from 90 cents per therm to 78 cents, or approximately 13 percent. Such a decrease is not enough to stifle a conservation incentive, particularly given that customers have seen substantial increases in gas commodity costs over the past few years. A 12-cent per therm decrease in volumetric margin (from 90 cents to 78 cents) is dwarfed by recent increases in gas commodity costs.

Although natural gas prices are difficult to predict, they are not expected to decrease significantly in the foreseeable future. As such, the pass-through costs contained in the PGA will continue to give customers ample incentive to conserve regardless of the Company's volumetric margin rate. Neither Staff nor RUCO present any evidence to support their contention that a 12-cent decrease in the volumetric margin rate will reduce conservation. Common sense suggests that significant per-therm gas costs – not to mention the remaining 18 cent-per-therm margin rate – will provide customers with ample incentives for conservation.

III. THROUGHPUT ADJUSTMENT MECHANISM.

In its application, UNS Gas has proposed a Throughput Adjustment Mechanism ("TAM"). The TAM would either reduce or increase the collection of volumetric margin revenues to match anticipated levels. This mechanism also would allow UNS Gas to implement the proposed comprehensive energy conservation program without threatening the volumetric margin revenues needed to serve its customers' growing needs and earn a fair rate of return. Under the TAM, the under-recovery in any period would be "trued-up" in future periods through use of a volumetric

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[233] See Ex. UNSG-9 (Schedule H-3).
[234] Ex. UNSG-19 at 11.

surcharge. Similarly, any over-recovery would be refunded to customers through a volumetric credit on future bills. As an alternative to an annual true-up of the margin rate, establishing a deferred throughput adjustment account is acceptable to UNS Gas.

The TAM is a type of decoupling mechanism that has gained growing support throughout the industrial and environmental communities. As Mr. Erdwurm noted in his pre-filed Rebuttal Testimony, in July 2004, the Natural Resources Defense Council ("NRDC"), the American Council for an Energy-Efficient Economy ("ACE[3]") and the AGA issued a statement to the National Association of Regulatory Utility Commissioners ("NARUC") supporting "mechanisms that use modest automatic rate true-ups to ensure that a utility's opportunity to recover authorized fixed costs is not held hostage to fluctuations in gas retail sales."[235] Further, NARUC adopted a resolution encouraging state commissions to approve rate designs such as the decoupling mechanism UNS Gas has proposed here.[236] At least 10 states have adopted some form of a decoupling mechanism, while several others are considering such a move.[237] Like these measures, the TAM is designed to separate natural gas consumption from UNS Gas' revenue recovery ability and, ultimately, its financial stability and viability.

A. The TAM is an Effective Means to Break the Link Between Natural Gas Use and Revenue Recovery that is Fair to Both the Company and the Customer.

Due to the volumetric nature of UNS Gas' current rates, the Company's return is highly dependent on customer usage. A cold winter can lead to a surge in usage-based revenues, while lower than expected usage can impede the Company's opportunity to earn its authorized rate of return.[238] Since the costs of operating a gas distribution service are largely independent of customer usage, this linkage makes little sense. Indeed, why should the Commission, Staff, RUCO, the Company and other parties to this rate case devote months to establishing the precise levels of recoverable cost, only to leave the actual recovery of those costs subject to the whims of

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[235] Ex. UNSG-19 at 17-18 and Ex. DBE-3 thereto.
[236] Ex. UNSG-19 at 18 and Ex. DBE-4 thereto.
[237] Ex. UNSG-37.
[238] Ex. UNSG-18 at 15; Tr. at 480.

consumer preference and Mother Nature? If the best answer to that question is that "we've always done it that way," it may be time for another approach.

The TAM was designed to cut the yoke that tethers revenues to usage, a change that serves the interests of both the Company and its customers. If the Company under-recovers its margin due to less gas consumption, then a volumetric surcharge would "true-up" recovery in future periods. But if the Company over-recovers its margin due to increased gas consumption during a cold winter, those excess revenues can be refunded through a volumetric credit to customers.[239] Exhibit TLV-2 details the Company's proposal.[240]

By minimizing the impact of weather on customer bills, the TAM provides for more equitable rate design by ensuring that customers do not pay more or less for "fixed costs" than they would under normal weather conditions.[241] The TAM also encourages conservation by reducing the conflict between conservation efforts and the Company's financial stake in the volumetric revenues associated with natural gas usage.[242] In so doing, it aligns the goals of conservation with the Company's interest in achieving its authorized rate of return.[243]

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B. None Of The Criticisms Levied Against Approving The TAM Are Supported By The Evidence.

RUCO asserts that the TAM would eliminate the incentive to conserve.[244] This position reflects a fundamental misunderstanding of the TAM, which is based on system-wide usage levels, not individual consumption. All customers would receive bills with identical TAM adjustments based on cumulative system usage, not their own household consumption. So a customer would continue to benefit from conserving energy in his own home since his individual actions would represent a tiny fraction of the usage data reflected in future TAM adjustments. Moreover, any TAM-related adjustments to customer bills would be dwarfed by the natural gas

[239] Ex. UNSG-18 at 12.
[240] Ex. UNSG-18 at Ex. TLV-2.
[241] Ex. UNSG-19 at 15.
[242] Ex. UNSG-18 at 15.
[243] Tr. at 481, 927.
[244] Ex. RUCO-5 at 31.

costs an individual customer could avoid through conservation. So even though system-wide reductions in usage could lead to higher TAM surcharges, individual customers will retain a strong incentive to conserve gas.

The second criticism, leveled by both Staff and RUCO, is that the TAM will remove the risk of revenue recovery. In fact, the TAM is designed to recover only those test year distribution costs established in the rate case. It cannot recover increases in distribution costs that occur after the test year, leaving the Company exposed to rising expenses.[245] Staff's witness, Mr. Ruback, admits that net income will fall if costs are not controlled even with the TAM in place.[246] In addition, the TAM does not address increased capital expenditures associated with the levels of customer growth that UNS Gas will likely continue to experience.[247] Because the Company has incentive to maximize its net income, it has a strong incentive to control its costs.[248] That incentive remains with the TAM.

The proposed TAM differs significantly from the "conservation margin tracker" proposed by Southwest Gas in its last rate case. UNS Gas has proposed associating the TAM with a deferred throughput adjustment account.[249] This could prevent the Company from imposing a surcharge at the same time a colder than normal winter is anticipated. Also, small volume customers are subject to the TAM under UNS Gas' proposal; only residential customers were subject to the decoupling charge Southwest Gas originally proposed.[250] In Decision No. 68487 (February 23, 2006), the Commission indicated its willingness to further consider a decoupling mechanism; thus UNS Gas proposed a decoupling mechanism that is more flexible and more inclusive than the one Southwest Gas offered.

Finally, Staff's witness Mr. Ruback asserted that the TAM does not satisfy the three tests that determine what he considers to be an automatic adjustment clause.[251] Mr. Ruback concedes,

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[245] Ex. UNSG-19 at 14-15.
[246] Tr. at 794.
[247] Ex. UNSG-19 at 15.
[248] Ex. UNSG-20 at 6.
[249] Ex. UNSG-18 at 14.
[250] Ex. UNSG-18 at 14.
[251] Tr. at 789.

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though, that he has never supported any decoupling mechanism, as none have apparently met his standard.[252]

If the Commission truly wants to align conservation goals with the Company's interest in recovering its revenue requirement, it should provide UNS Gas with a better opportunity to do so. The Company proposes the TAM as a reasonable way to achieve this alignment. While innovative, it has support from NRDC, NARUC, and ACE[3] and has been approved, in some form, in at least ten other states. No other party has suggested any other means to align Company and conservation interests. Moreover, UNS Gas has pledged to continue supporting DSM regardless of the disposition of its TAM proposal. No party can accuse the Company of using the TAM as leverage for its continued support of DSM. For all of these reasons, and based on evidence in the record, the Commission should approve the TAM as being in the public interest and advancing the goals of conservation without unduly jeopardizing the Company's financial stability.

IV. DEMAND-SIDE MANAGEMENT.

In this docket, the Company proposes an aggressive Demand-Side Management ("DSM") portfolio with several new programs, including the Residential Furnace Retrofit Program, the Residential New Construction Home Program, the Commercial HVAC Retrofit Program and the Commercial Gas Cooking Efficiency Program.[253] The total funding for these four new programs is $916,616.[254] UNS Gas also proposes to expand its Low-Income Weatherization ("LIW") program and reclassify that program as DSM. The total cost for the expanded LIW program is $135,000.[255] UNS Gas is proposing $1,051,616 annually for its DSM portfolio. Further, the Company believes these programs will provide a net benefit to society.[256]

UNS Gas is largely in agreement with Staff's recommendations. For instance, UNS Gas agrees to file (and indeed filed on May 4, 2007) specific program proposals with significant detail

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[252] Tr. at 796.
[253] Ex. UNSG-15 at 13-15; Tr. at 519.
[254] Ex. UNSG-15 at 14-15.
[255] Ex. UNSG-15 at 14.
[256] Tr. at 519-20.

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for Staff's review and the Commission's approval.[257] As Ms. Denise A. Smith testified, the Company prefers to have the new programs and the expanded LIW program approved in this docket so those programs can be implemented as soon as possible.[258] The Company's preference also comports with Commissioner Mayes' request at the pre-hearing conference.[259] UNS Gas also understands that Staff believes it needs more time to examine the program proposals. In light of that, the Company is attempting to be responsive to both Staff's position and the Commissioner's request. In fact, UNS Gas has filed its program proposals both in this docket and as an application in a separate docket, Docket No. G-04204A-07-0274 (May 4, 2007).

UNS Gas also has agreed to use Staff's Societal Cost Test, despite its original uncertainty about how Staff defined the test and how to calculate it.[260] The Company has recognized that Staff and the Commission have used a Societal Cost Test as its key measure to determine the cost-effectiveness of DSM programs.[261] Ms. Smith also has highlighted the usefulness and the importance of using all DSM tests to fully and completely analyze each DSM program.[262] Specifically, the Participant Test, the Total Resource Cost Test, and the Rate Impact Measure Test can provide valuable and different information directly relevant in determining the effectiveness of a particular DSM program.[263] In short, UNS Gas believes a more complete evaluation results from using all available tests, including the Company's understanding of the Societal Cost Test.

Further, although the Company believes that a full year offers a more meaningful reporting period, the Company will provide reports to the Commission every six months, with an option to change that requirement to an annual basis once the programs are established and are meeting goals in a cost-effective manner.[264]

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[257] See Ex. UNSG-21 at 8-9; UNSG-23.
[258] Tr. at 518.
[259] See April 13, 2007 Pre-Hearing Conference Transcript at 25:3-14.
[260] Ex. UNSG-21 at 4, 7; Ex. UNSG- 22 at 2; Tr. at 556.
[261] Tr. at 556.
[262] Ex. UNSG-22 at 2-3.
[263] Ex. UNSG-21 at 7 and Ex. DAS-2 thereto.
[264] Ex. UNSG-21 at 10; Ex. UNSG-22 at 4.

Finally, the Company will agree to initially including just 25 percent of the new DSM program costs ($230,000) plus the expanded LIW program costs ($113,400) and the cost of the baseline study needed to thoroughly evaluate the effectiveness of DSM programs ($82,000) included in the DSM adjustor (for a total of $425,400).[265] This would produce a DSM adjustor charge of $0.0031 per therm upon approval of this case.[266] Past Commission decisions offer persuasive authority to justify approving the total amount, $1,051,616, for its DSM programs in this case. This higher amount is proportionally similar (based on a comparison of company size vs. program cost) to what the Commission approved for Arizona Public Service Company ($16 million) and Southwest Gas ($4.385 million).[267] Even so, the Company is willing to move forward expeditiously with a DSM adjustor charge initially set at only $0.0031 per therm.[268]

V. CARES DISCOUNT/LOW-INCOME CUSTOMER ISSUES.

A. A Year-Round $6.50 Per Month Discount to the Customer Assistance Residential Energy Support Program with the Company's Proposed Rate Design is in the Best Interest for Low-Income Customers.

The Company has proposed a year-round discount of $6.50 per month for qualifying low-income customers, guaranteeing savings of $78 per year.[269] Under the volumetric discounts offered through the current CARES program, customers can save up to $15 per month during the winter months, November through April, if they use up to 100 therms per month. Although this allows a maximum annual discount of $90, the average CARES participant realizes savings of just $58.[270] In other words, customers under the current system only receive the maximum CARES discount if their consumption is high – thus driving up their bills. The revised program would eliminate this paradox.

Staff contends that the Company's proposal eliminates low-income customers' incentive to conserve. Like other customers, though, CARES participants would still face significant

[265] Ex. UNSG-21 at 9; Ex. UNSG-22 at 3.
[266] Ex. UNSG-22 at 3.
[267] See Decision No. 67744 at 20; Decision No. 68487 at 61-63, 66.
[268] Tr. at 554.
[269] Ex. UNSG-15 at 10.
[270] Ex. UNSG-18 at 10.

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volumetric charges, including gas costs that currently amount to 60 to 70 cents per therm. These costs would provide plenty of incentive to conserve independent of how the CARES discount is structured.[271]

Staff's other objections to the proposed CARES program echo its arguments against the Company's proposed rate design in general – as do UNS Gas' responses. Eliminating the cross-subsidies between customers in cold and warm climates would help low-income customers in cold climates who depend on gas for necessities like heat and hot water. Meanwhile, UNS Gas' proposal for seasonal monthly customer charges would reduce pressure on winter bills while making it easier for low-income customers to budget for their energy expenses.

Finally, most low-income customers will face only modest increases under the Company's proposed rate design. For instance, in the winter, a low-income customer on CARES using 100 therms per month would face an increase of $1.12 per month, from $22.00 to $23.12. In the summer, that same CARES customer using 20 therms would face an increase from $13.01 to $17.22.[272] By scaling back the proposed higher customer charge for low-income customers, the Company has attempted to minimize the impact of its new rates on CARES customers. Indeed, some CARES customers with higher than average gas usage may actually experience a rate decrease due to the Company's proposed reduction in per-therm charges.[273] For these reasons, UNS Gas believes the proposed monthly discount of $6.50 for CARES participants serves the best interests of its qualified low-income customers.

B. UNS Gas Reiterates its Commitment to Work with the Arizona Community Action Association on Low-Income Customer Issues.

UNS Gas is aware that several other issues pertaining to low-income customers were raised by other parties, including the Arizona Community Action Association ("ACAA"). To address these issues, UNS Gas makes several commitments to improve its service to low-income customers:

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[271] Ex. UNSG-19 at 20.
[272] Ex. UNSG-9 (Schedule H-4 at 2).
[273] Id.

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- The Company is committed to automatically enrolling customers eligible for the Low-Income Home Energy Assistance Program ("LIHEAP") into the CARES program.[274] The Company has made significant strides to enroll low-income customers, as Staff has recognized, and will continue to expand its outreach efforts. These efforts include distributing CARES applications to local assistance agencies, public libraries and local municipal buildings and promoting the program through bill inserts included in residential customer bills every quarter.[275]
- UNS Gas will conduct further inquiries about predatory practices at payday loan businesses upon receiving specific information from the ACAA. UNS Gas is not encouraging any customer to obtain loans from these operations and ACAA presents no evidence to the contrary. UNS Gas covers any fees related to the payment of gas bills at locations where it does not have an office. Further, the Company will continue its efforts to provide low-income customers with numerous options for paying their bills.
- The Company is willing to explore further opportunities to increase the marketing of its low-income programs to low-income customers.
- The Company has agreed to increase the LIW funds to the agencies.
- The Company will maintain its commitment to tap shareholder funds to match customer contributions to the Warm Spirit program, which usually range from $20,000 to $25,000 per year.[276]
- Finally, UNS Gas agrees that the $21,600 it originally proposed for emergency bill assistance through the LIW program be moved to the Warm Spirit program and recovered in base rates.[277]

These steps are clear evidence of the Company's commitment to ease the burden on low-income customers as much as possible.

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[274] Ex. UNSG-16 at 8.
[275] Ex. UNSG-17 at 4.
[276] Ex. UNSG-15 at 11.
[277] Ex. UNSG-16 at 3.

VI. RULES AND REGULATIONS.

A. UNS Gas Proposes Changes to Increase Contributions from Developers and Customers Seeking Service and Main Line Extensions.

UNS Gas has proposed a number of changes to its Rules and Regulations ("Proposed Rules") to reflect increased costs and current market conditions, and to ensure that developers and new customers pay a fair cost for the infrastructure connecting new developments and new customers to the UNS Gas system.[278] The Company proposes changes to both its service line and main line extension policies, as detailed in Exhibit GAS-2 to Mr. Gary Smith's Direct Testimony. The Company also presented other possible changes in these policies that could be adopted if the Commission would prefer to have more of these facilities subsidized by new customers and developers. The Company believes all of these changes allow for consideration of the specific cost and impact of extensions and therefore represent an improvement over the hook-up fee concept.[279]

The Company's proposals can be summarized as follows:

- For a new gas service line, the customer will reimburse the Company at a rate of $16 per foot on the customer's property. For customers who provide the trench for the service line, the rate will be $12 per foot. Currently, the rate is $8 per foot.[280]
- There will be no free footage for developers under the UNS Gas proposals; developers will have to contribute the entire amount up front.[281]
- The incremental contribution study, or "ICS", component will be modified to reduce the credit to new customers and developers per service line or main extension.[282] This ensures that the cost burden is initially put on the customer or developer for main or service line extensions.[283] The developer could be reimbursed over a five-year period for line extensions.[284] The purpose of the ICS, however, is to consider the specific cost

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[278] Ex. UNSG-15 at 19-20.
[279] Tr. at 919; Tr. at 1049.
[280] Ex. UNSG-15 at 19.
[281] Tr. at 386.
[282] Ex. UNSG-35.
[283] Tr. at 387.
[284] Tr. at 384.

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and benefit to the system for adding that customer.[285] The Company's ICS was an effort to have an economic feasibility system in accordance with A.A.C. R14-2-307.

- For line extensions over $500,000, UNS Gas would add a gross-up amount equal to the Company's estimated federal, state and local income tax liability in advance.[286]

It is estimated that these changes would bring in an additional $3.6 to $3.8 million per year, on average.[287] Later in the evidentiary hearing, UNS Gas presented two additional potential modifications:

- Eliminating the ICS and retaining the language that customers pay for the entire length of the service line on their property.[288] This measure will provide an estimated $1.2 million of additional contributions per year.[289]
- Requiring that customers/developers pay for the excess flow valves, mandatory for new service lines starting in July of 2008. Those valves cost $250 apiece.[290]

The Company does not recommend adopting both additional measures because they would increase the contribution from $310 to almost $1,000. UNS Gas also would prefer its original proposal.[291] The Company is mindful of potential competition from propane carriers and electric providers and wants developers to be comfortable with the ICS modifications proposed in this case.[292] Further, Staff witness Mr. Smith appeared to believe that a feasibility study could be helpful in ensuring that the Company gets adequate margins to economically justify new lines.[293] The ICS helps UNS Gas specifically tailor a new customer's or developer's up front payment and is in accordance with Commission regulations. Further, because not all developments are fully built-out after five years, any funds not refunded by that time become a contribution.[294] All of the

[285] Tr. at 919.
[286] See Ex. UNSG-15 at Ex. GAS-2 (Subsection 7.D.16.)
[287] See Ex. UNSG-30; Tr. at 915.
[288] Ex. UNSG-31.
[289] Tr. at 916.
[290] Ex. UNSG-32; Tr. at 1067.
[291] Tr. at 1069.
[292] Tr. at 1070-72.
[293] Tr. at 869 – 871.
[294] Tr. at 1055.

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Company's proposals strive to hold developers and new customers responsible for a fair share of the costs of additional facilities needed to serve growth.

B. The Company's Proposed Billing Terms are Reasonable and in Accordance with Commission Regulations.

The Company proposes to modify its billing terms to conform its payment terms with the Arizona Administrative Code.[295] RUCO argues that this is unreasonable. RUCO is, in effect, arguing that the Commission's own rules on this issue are unreasonable. Obviously, that is not the case.

Under the Company's Proposed Rules, a customer would have 10 days to pay a bill before it is considered late. The customer would have an additional 15 days before a late fee is assessed. The Company would then wait an additional five days before beginning suspension of service procedures.[296] This timetable provides ample opportunity for customers who might be away from their home when a bill arrives to make payment before their service is interrupted. Moreover, the Company has the option of delaying suspension procedures in exigent or unusual circumstances.[297] Nevertheless, the Company would agree to a six-month waiver so that customers can get used to the change in the billing terms, if approved.[298]

VII. THE PURCHASED GAS ADJUSTOR SHOULD BE MODIFIED.

In its application for review and revision of the PGA, UNS Gas identified four substantial problems with the current structure of the PGA: (1) a large and rapidly increasing bank balance, which places financial strain on UNS Gas; (2) funding for other needed projects can be constrained because of resources devoted to funding the bank balance; (3) the PGA band is too narrow, resulting in charges that do not reflect the true cost of gas; and (4) UNS Gas suffers a loss on each positive dollar in the bank balance because it pays higher interest to fund the balance than it is allowed to recover from customers. UNS Gas requested that the PGA be modified as follows:

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[295] See A.A.C. R14-2-310.C.
[296] Ex. UNSG-16 at 4; see Ex. UNSG-15 at Ex. GAS-2 (Subsection 10.C).
[297] See Ex. UNSG-15 at Ex. GAS-2 (Subsection 11.C).
[298] Ex. UNSG-17 at 2.

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1. Bandwidth. The band should be eliminated or, in the alternative, temporarily increased to $.25 per therm, and then eliminated.

2. Increase Interest. The interest earned on the PGA bank balance should reflect UNS Gas' actual cost of new debt, which is LIBOR plus 1.5 percent.

3. Regulatory Asset. When the bank balance is greater than two times the threshold level, UNS Gas should earn its weighted average cost of capital as determined in its most recent rate case; currently, this is 9.05 percent.

4. Symmetrical threshold. The new threshold level of $6,240,000 for under-collected bank balances established in Decision No. 68325 should be adopted as the threshold level for over-collected bank balances.

5. Capital Structure. The Commission should declare that it will not include debt related to the bank balance in UNS Gas' capital structure for the purpose of calculating UNS Gas' weighted average cost of capital.

6. Surcharges. When surcharges are needed, the Commission should approve a surcharge large enough to eliminate the bank balance within a reasonable time period.

The Parties agree about the majority of issues regarding the PGA. For instance, all agree that the entire cost for natural gas should be reflected in the PGA, and that the base cost of gas should be zero. That way, customers will have an easier time recognizing what costs are attributable to natural gas itself and how that expense affects their bill. All agree that some widening of the bandwidth is appropriate. UNS Gas also agrees with Staff's recommendations to eliminate the under-collection threshold for filing for a PGA Surcharge, and to set the over-collection threshold at $10 million.[299] The two issues in dispute are (i) the appropriate levels for the bandwidth; and (ii) the PGA bank interest rate.

[299] Ex. UNSG-5 at 4.

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The Company still believes that using a 12-month rolling average for gas costs provides a significant smoothing of gas costs for customers.[300] The bandwidth only increases the lag between actual gas expenses and the costs customers pay for natural gas in a certain month.[301] In this way, accurate price signals are diluted and, as one Commissioner is fond of noting, the proverbial can is kicked further down the road. While UNS Gas supports having some smoothing mechanism in place to restrict the month-to-month movement of natural gas costs, employing two such mechanisms ultimately does more harm than good. With the 12-month rolling average in use, the PGA bandwidth restrictions should be lifted entirely. The bandwidth creates an extra and unnecessary disconnect from actual gas prices, causing large deferrals for the Company and significant carrying costs to be passed along to customers.[302]

Understanding that neither Staff nor RUCO agree with the Company, UNS Gas proposed a compromise by accepting RUCO's recommendation to expand the bandwidth to 20 cents per therm from the current limitation at 10 cents per therm.[303] Staff is recommending expanding the bandwidth to 15 cents per therm. UNS Gas acknowledges Staff's recommendation is an improvement and would help reduce the lag but maintains that a 20 cent-per-therm bandwidth is still preferable for the reasons described above. Unfortunately, the natural gas market, like the markets for gasoline, crude oil and other fossil fuels, will remain volatile for the foreseeable future. While UNS Gas understands the need to smooth out natural gas prices for its customers, that need must be balanced against the need to send more accurate price signals and avoid large deferrals caused by volatile gas prices.[304] UNS Gas simply believes that while one smoothing mechanism (the 12-month rolling average) is appropriate, adding a second mechanism (the bandwidth) goes too far. If there is going to be a bandwidth, however, it should be set no narrower than 20 cents per therm.

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[300] Ex. UNSG-5 at 2-3; Tr. at 173.
[301] Ex. UNSG-5 at 3.
[302] Tr. at 159, 174.
[303] Ex. UNSG-5 at 4; Tr. at 159.
[304] Tr. at 176-78.

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The volatile energy market also has impacted UNS Gas' actual cost of borrowing to cover larger-than-expected PGA bank balances in the past few years. In response, UNS Gas proposed two PGA bank interest rates: first, LIBOR plus 1 percent; and second, the weighted average cost of capital, to be used only when the bank balance exceeds $6.24 million. While the PGA bank interest rate may not have been created with the intent that it reflect the actual costs of borrowing, it also was expected that the PGA bank balance would be close to zero. UNS Gas simply believes the realities of the current landscape justify an interest rate that more accurately reflects the costs UNS Gas actually incurs in carrying today's significant PGA bank balances.

VIII. THE COMMISSION SHOULD CONFIRM THAT UNS GAS' PROCUREMENT PRACTICES HAVE BEEN PRUDENT AND APPROVE UNS GAS' PRICE STABILIZATION POLICY.

There are two procurement issues in this docket. The first involves Staff's conclusions regarding UNS Gas' procurement practices and the second involves UNS Gas' request for approval of the Company's Price Stabilization Policy (i.e., its gas procurement and hedging policy).

First, UNS Gas is pleased that Staff finds its procurement practices to have been reasonable and prudent. UNS Gas requests that the Commission confirm that UNS Gas' past gas procurement was prudent.

Second, UNS Gas believes that approving the Price Stabilization Policy is appropriate, because it would provide some up-front assurance about its planed course of action regarding future purchase. It would be far more productive to get all stakeholders involved on the front end, versus after-the-fact.[305] Because purchases are made as much as three years out, it is beneficial to have some record in case personnel for the various parties have changed.[306] It is for these reasons that having some approval of the Price Stabilization Policy is warranted. Even so, the Company is committed to continuing to look for ways to purchase gas most economically, including exploring

[305] Tr. at 137, 157.
[306] Tr. at 139.

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other providers of scheduling and system optimization services, and updating Staff with information relating to negotiations or reconciliations.[307]

IX. REQUEST FOR ACCOUNTING ORDER.

UNS Gas has requested that its legal expenses for its participation in FERC rate cases that will affect the cost of gas purchased by UNS Gas be included as an expense related to its test year operating income. If the Commission decides to disallow those legal expenses as an operating expense, the Company requests an accounting order that would allow all legal expenses related to FERC gas rate cases to be included in the cost of gas covered by the PGA.

X. CONCLUSION.

UNS Gas respectfully requests that the Commission issue a final order:

(1) granting the Company the permanent rate increase sought herein;

(2) approving the new or modified rate and service schedules with an effective date no later than October 1, 2007;

(3) authorizing UNS Gas' depreciation rates and classifications;

(4) approving the Throughput Adjustment Mechanism;

(5) approving the requested modifications to UNS Gas' low-income support programs;

(6) approving UNS Gas' revised Rules and Regulations, including the Company's revised line extension tariff;

(7) approving UNS Gas' Price Stabilization Policy;

(8) finding that UNS Gas' gas procurement was prudent;

(9) approving UNS Gas' proposed DSM adjustor mechanism and proposed resulting charge;

(10) approving the requested revisions to UNS Gas' Purchased Gas Adjustor;

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[307] Tr. at 151-51, 155-56.

(11) allowing certain UNS Gas' FERC rate case legal expenses be recovered through the PGA (assuming those legal expenses are disallowed as part of operating expenses); and

(12) granting the Company such additional relief as the Commission deems just and proper.

RESPECTFULLY SUBMITTED this 5th day of June 2007.

UNS Gas, Inc.

By ______________________

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ATTACHMENT

"1"

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	As Filed 7/13/06 UNSG	Surrebuttal 4/4/07 ACC Staff	Surrebuttal 4/4/07 RUCO	Rejoinder 4/11/07 UNSG	Summary	UNSG Witness
						Kissinger
Original Cost Rate Base - Unadjusted	$149,791,159	$149,791,159	$149,791,159	$149,791,159		
Rate Base Adjustments						
Acquisition Adjustment (RUCO Rate Base Adjustment No. 3)	35,277,589	35,277,589	35,028,702	35,277,589	RUCO adjusts the acquisition discount amortization claiming that the depreciation rates currently in use were not approved in the last rate case. UNSG is defending use of the rates. These were the rates used to derive depreciation expense in the Decision approving UNSG's current customer rates and were approved as such.	Kissinger
Southern Union Acquisition Premium	(17,053,753)	(17,053,753)	(17,053,753)	(17,053,753)	No adjustments	Kissinger
Griffith Power Plant	(5,254,086)	(5,254,086)	(5,254,086)	(5,254,086)	No adjustments	Kissinger
CWIP (Staff Adjustment B-1, RUCO Rate Base Adjustment No. 4)	7,189,231	-	-	7,189,231	Staff & RUCO exclude CWIP as not in service at test year end. UNSG defends its position for economic reasons and because the plant is in service prior to new rates being established. UNSG also asserts double jeopardy as there is $4.2 million in customer advances directly related to projects in this CWIP balance that have been included as a reduction of rate base.	Grant
Build-Out-Plant	(8,700,572)	(8,700,572)	(8,700,572)	(8,700,572)	No adjustments	Kissinger
CARES Asset	(1,662)	(1,662)	(1,662)	(1,662)	No adjustments	Kissinger
GIS Deferral (Staff Adjustment B-2, RUCO Rate Base Adjustment No. 5)	897,068	-	-	897,068	Staff & RUCO exclude the GIS expenditures from rate base primarily because UNSG did not get an accounting order from the Commission. They believe the costs are non-recurring and not eligible for rate base treatment. UNSG asserts that the costs were initially thought to be capital costs and the error was not detected until the fourth quarter of 2005. At that point the expenditures had already been made and it was impossible to request an accounting order in advance. The income statement impact did happen in the test year and no one argued that the costs were imprudent. The record shows the costs were at least partially incurred at the request of the Commission and benefit present and future customers.	Dukes
Pre-Acquisition Plant in Service (RUCO Rate Base Adjustment No. 1)	-	-	(6,990,677)	-	RUCO is claiming that UNSG cannot substantiate $3.1 million of plant additions added between 12/31/01 and 8/11/03. RUCO also contends that the level of accumulated depreciation as of 12/31/03 was incorrect based on their recalculation. UNSG strongly disagrees with RUCO's assertion.	Kissinger
Accumulated Depreciation (RUCO Rate Base Adjustment No. 2)	-	-	(2,855,454)	-	RUCO claims that since August 2003, UNSG has been using depreciation rates that were not approved by the Commission. UNSG is defending use of the rates. These were the rates used to derive depreciation expense in the Decision approving UNSG's current customer rates and were approved as such.	Kissinger
Customer Contributions	-	-	-	-	No adjustments	Kissinger
Other Rate Base (Y2K & Warm Spirit)	-	-	-	-	No adjustments	Kissinger
Accumulated Deferred Income Taxes (Staff Adjustment B-4)	2,807,892	3,003,228	2,807,892	2,807,892	Staff's differences are because of proposed rate base adjustments. RUCO did not adjust deferred taxes to synchronize with their proposed adjustments.	Kissinger
Working Capital (Staff Adjustment B-3, RUCO Rate Base Adjustment No. 6)	(3,291,503)	(2,514,629)	(2,125,388)	(2,594,009)	Staff & RUCO agreed with UNSG's lead/lag study after the correction supplied to them in response to Staff Data Request 5.76. The remaining differences arise primarily from varying adjustments and as a result of not completing a simultaneous equation to synchronize. Staff and RUCO adjustments are revised as a result of changes in other pro formas in their Surrebuttal testimony.	Kissinger
Total Adjustments	11,870,204	4,756,115	(5,144,998)	12,567,698		
Pro Forma Original Cost Rate Base	161,661,362	154,547,273	144,646,160	162,358,856		
Requested Rate of Return	8.80%	8.12%	8.22%	8.80%	Staff recommends a 10% ROE and no hypothetical capital structure. RUCO recommends a 9.64% ROE and a 50/50 hypothetical capital structure. RUCO also calculated the cost of debt excluding debt issuance cost. RUCO adjusted it's recommendation for ROE to 9.84% and long-term dedt to 6.23% to reflect current market conditions.	Grant
Required Operating Income	$14,223,179	$12,549,239	$11,889,914	$14,284,546		

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	As Filed 7/13/06 UNSG	Surrebuttal 4/4/07 ACC Staff	Surrebuttal 4/4/07 RUCO	Rejoinder 4/11/07 UNSG	Summary	UNSG Witness
Original Operating Income - Unadjusted	$10,590,155	$10,590,155	$10,590,155	$10,590,155		Kissinger
Operating Income Adjustments						
Operating Revenue Adjustments						
Griffith Plant Operations	(865,152)	(865,152)	(865,152)	(865,152)	No adjustments	Dukes
Purchased Gas Cost & Gas Cost Revenue	(75,545,465)	(75,545,465)	(75,545,465)	(75,545,465)	No adjustments	Dukes
Customer Annualization (Staff Adjustment C-1, RUCO Operating Income Adjustment No. 14)	725,682	828,115	835,688	725,682	Both Staff & RUCO used year-end customer levels with no adjustments for the cyclical pattern of customer counts. UNSG used a slightly modified method to take into account the recurring customer level losses that happen each and every summer when customers leave the system.	Erdwurm
Weather Normalization (Staff Adjustment C-2, RUCO Operating Income Adjustment No. 15)	516,921	518,883	517,821	516,921	The differences here are primarily because the weather normalization adjustment starts with the annualized customer counts, revenues and sales.	Erdwurm
NSP Revenue & Gas Cost	(15,738,093)	(15,738,093)	(15,738,093)	(15,738,093)	No adjustments	Dukes
CARES	(203,181)	(203,181)	(203,181)	(203,181)	No adjustments	Dukes
Total Adjustments to Operating Revenues	(91,109,288)	(91,004,893)	(90,998,382)	(91,109,288)		
Operating Expense Adjustments						
Griffith Plant Operations	(164,614)	(164,614)	(164,614)	(164,614)	No adjustments	Dukes
Purchased Gas Cost & Gas Cost Revenue	(75,545,465)	(75,545,465)	(75,545,465)	(75,545,465)	No adjustments	Dukes
NSP Revenue & Gas Cost	(15,269,790)	(15,269,790)	(15,269,790)	(15,269,790)	No adjustments	Dukes
Payroll Expense (Staff Adjustment C-8 & C-9)	440,550	317,540	440,550	369,928	RUCO accepted UNSG's payroll adjustment. Staff adjusted UNSG's overtime levels and incorrectly adjusted an error that they found in our adjustment. UNSG accepted the overtime adjustment proposed by Staff and corrected the error in the original UNSG pro forma adjustment. Staff adjustment is revised to reflect that their original Adjustment No. C-8 is no longer necessary and that the $52,388 credit to expense for the one-time severance should be excluded from payroll expense. However, Staff and RUCO still exclude the error correction of UNS Gas originial adjustment.	Dukes
Payroll Tax Expense (Staff Adjustment C-10)	25,907	16,559	25,907	20,567	Adjustments reflect changes to payroll expense. Staff adjustment is revised to reflect the change in their Adjustment No. C-8.	Dukes
Pension & Benefits (RUCO Operating Income Adjustment No. 11)	54,594	54,594	(38,481)	54,594	RUCO is excluding SERP charges allocated to UNSG. UNSG believes that SERP is a part of a fair and reasonable executive compensation program and should not be excluded based on IRS limits established to maximize tax revenues.	Dukes
Post Retirement Medical	57,676	57,676	57,676	57,676	No adjustments	
Worker's Compensation (Staff Adjustment C-13, RUCO Operating Income Adjustment No. 1)	34,234	-	-	-	The Company is agreeing with proposed adjustments.	Dukes
Incentive Compensation (Staff Adjustment C-6, RUCO Operating Income Adjustment No. 2)	137,262	(130,163)	(141,486)	137,262	Staff excluded 50% of the test year "incentive" compensation and 100% of SERP expenses ; RUCO excluded all incentive compensation. UNSG is opposing all adjustments and asserts that programs like the Performance Enhancement Plan actually saves customers money and the other programs are part of a fair and reasonable compensation plan for the Officers and Directors of UniSource.	Dukes
Rate Case Expense (RUCO Operating Income Adjustment No. 8; Staff Adjustment No. C-19)	200,000	85,000	83,667	300,000	Staff proposed no change to the Company's original adjustment. RUCO compared UNSG to SWG and took the amount SWG got in their last rate case and adjusted it for inflation. UNSG is updating the record for the latest projected cost. Staff adjustment No. C-19 is added to reflect Staff's rate case expense of $255,000 amortized at $85,000 per year.	Dukes
Bad Debt Expense (Staff Adjustment C-3, RUCO Operating Income Adjustment No. 17)	317,758	319,021	222,175	317,758	Staff used the UNSG adjustment and inserted revised customer annualization revenues. RUCO recalculated using our historical write-off rate times pro forma revenues (excluding NSP and Griffith); this would be correct had they corrected the write-off percentage to reflect the exclusion of those revenues as well.	Dukes
Interest On Customer Deposits	16,507	16,507	16,507	16,507	No adjustments	

UNS GAS, INC.
COMPARISON OF ADJUSTMENTS TO REVENUE REQUIREMENT
TEST YEAR ENDED DECEMBER 31, 2005

	As Filed 7/13/06 UNSG	Surrebuttal 4/4/07 ACC Staff	Surrebuttal 4/4/07 RUCO	Rejoinder 4/11/07 UNSG	Summary	UNSG Witness
Operating Expense Adjustments (cont'd)						
Fleet Fuel Expense (Staff Adjustment C-15, RUCO Operating Income Adjustment No. 13)	73,726	61,069	24,176	61,068	Both Staff & RUCO used calculations similar to the UNSG adjustment, except that RUCO used test year average fuel cost and Staff used a recent three-month average for the State of Arizona. UNSG accepts Staff's proposed method, but used the most recent three-month average actual fuel cost for UNS Gas instead of an Arizona average. Staff adjustment is revised to reflect the change in their Adjustment No. C-15 to match UNSG's rebuttal testimony amount.	Dukes
Amortization of GIS Expenditures (Staff Adjustment C-5, RUCO Operating Income Adjustment No. 12)	(541,344)	(840,367)	(840,367)	(541,344)	Staff & RUCO excluded GIS, saying UNSG didn't have an ACC order to defer the cost. UNSG argues that the expense was booked in the test year and the Commission has authority to grant the Company's requested treatment.	Dukes
Out of Period Expenses (RUCO Operating Income Adjustment No. 19)	(43,743)	(43,743)	(64,863)	(43,743)	RUCO is excluding some PWC invoices for services provided in 2004 and expensed in 2005; however, RUCO did not look at the 2005 invoices expensed in 2006 that were essentially equivalent. UNSG recommends no change to its original adjustment.	Dukes
Year-End Accruals	(125,000)	(125,000)	(125,000)	(125,000)	No adjustments	Dukes
Advertising & Donations	(16,619)	(16,619)	(16,619)	(16,619)	No adjustments	Dukes
Postage Expense (Staff Adjustment C-16, RUCO Operating Income Adjustment No. 4)	142,707	116,683	90,856	142,707	Staff took test year expense and increased it for the postage rate increase. RUCO took a similar approach, but has a formula error in their calculation and also forgot to pick up other postage expense. Both parties ignored the fact that there was a $58k prior period adjustment in the test year that needed to be corrected in their starting number. When those issues are corrected, the approaches are very similar but, their proposed amount is inadequate when compared to the two year average cost and the actual 2006 cost. Staff adjustment is revised to reflect the correct starting test year postage expense used by UNSG and the May 2007 increase in postage rates of $.02 for a first class letter. RUCO adjustment is revised to reflect the acceptance of UNSG test year total but still disallows the two-year average.	Dukes
CARES	(16,899)	(458,410)	(16,899)	(16,899)	No adjustments. Staff adjustment No. C-20 is added to reflect their proposed change in the accounting for CARES program costs and the elimination of deferred program costs.	Erdwurm & Dukes
Depreciation & Property Tax for CWIP (Staff Adjustment C-4, RUCO Operating Income Adjustment No. 18)	363,150	-	196,266	363,150	Staff excluded the adjustment for CWIP depreciation and property taxes completely. RUCO removed the property taxes and included the depreciation adjustment in their overall depreciation adjustment calculation. UNSG believes the CWIP in rate base should be allowed and disagrees with the proposed reductions.	Dukes
Gain on Sale of Prescott Property	(12,437)	(12,437)	(12,437)	(12,437)	No adjustments	
Corporate Cost Allocations (RUCO Operating Income Adjustment No. 16; Staff Adj. No. C-18)	130,471	117,706	117,706	117,706	Staff made no adjustments in direct testimony. RUCO found an invoice we had missed related to the KKR acquisition. Staff adjustment No. C-18 is added to reflect the change made by UNSG in response to RUCO's discovery of additional non-recurring merger costs.	Dukes
Customer Service Cost Allocations (RUCO Operating Income Adjustment No. 5)	325,422	325,422	(401,288)	325,422	Staff doesn't propose an adjustment. RUCO adjusts to an annualized incremental cost level based on having a handful of part-time CSR's, no system, inadequate phone lines and limited customer service. UNSG strongly opposes RUCO's adjustment.	Dukes
Depreciation Annualization	3,280	3,280	3,280	3,280		
Emergency Bill Assistance (Staff Adjustment C-7)	-	21,600	-	21,600	Staff argues should be in base rates and not in DSM surcharge. Company agrees with Staff's adjustment.	Dukes
Nonrecurring FERC Rate Case Legal Expense (Staff Adjustment C-11, RUCO Operating Income Adjustment No. 20)	-	(311,051)	(311,051)	(57,603)	Staff and RUCO exclude legal expenses related to the El Paso FERC case as non-recurring, despite the fact that we had legal expenses of $373k in 2004, $488k in the test year and $425k in 2006. This would put a two-year average right at our 2006 expense level; UNSG is proposing a two year average of 2004 & 2005 actuals.	Dukes
Membership & Industry Association Dues (Staff Adjustment C-14, RUCO Operating Income Adjustment No. 9)	-	(26,868)	(1,523)	(11,649)	Staff excludes 40% of AGA dues. RUCO excludes 3.6%. UNSG originally viewed this as immaterial; UNSG agrees with RUCO's adjustment.	Dukes
Pre-Acquisition Plant in Service Depr. Expense (RUCO Operating Income Adjustment No. 3)	-	-	(324,083)		RUCO reduces test year depreciation expense based on the recalculated plant in service balance. UNSG strongly opposes any exclusion of plant in service and strongly disagrees with RUCO's calculation of depreciation expense.	Kissinger

UNS GAS, INC.
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Operating Expense Adjustments (cont'd)						
Unnecessary Expenses (RUCO Operating Income Adjustment No. 6)	-	-	(233,347)	(27,968)	RUCO excluded over 2,000 immaterial charges for items such as hotels, meals, flowers, training and etc. UNSG defends the changes as necessary in the course of providing gas service and takes issue with RUCO's burdensome approach. UNSG adjusts expense to reflect acceptance of RUCO's adjustment to disallow $27,968 of expenses (Gary Smith Rejoinder)	Smith/Dukes
Nonrecurring Expenses (RUCO Operating Income Adjustment No. 10)	-	-	(2,584)	-	RUCO removed MARC training costs from expenses. UNSG is incurring ever-increasing employee levels, regulation and training requirements. It makes no sense to reduce any part of test year training cost.	Smith
Property Taxes (Staff Adjustment C-12, RUCO Operating Income Adjustment No. 7)	1,591,370	1,511,080	1,282,061	1,591,370	Staff & RUCO adjusted to match their plant in service and also reached out an additional year to 2007 for assessment rate reductions. UNSG disagrees with these adjustments.	Kissinger
Income Taxes (Staff Adjustment "All C's", RUCO Operating Income Adjustment No. 22)	(1,126,817)	(394,329)	321,341	(1,092,765)	All changes are recalculations based on other adjustments.	Kissinger
RUCO Operating Income Adjustment No. 20	-	-	-		RUCO error in Schedule RLM-7 as part of Operating Adjustment No. 20. RUCO removed their error of ($622,102) in their direct testimony within their Surrebuttal.	Dukes
Total Adjustments to Operating Expense	(88,948,114)	(90,315,119)	(90,627,729)	(89,025,302)		
Total Net Adjustments	(2,161,174)	(689,774)	(370,653)	(2,083,986)		
Adjusted Operating Income	$8,428,981	$9,900,381	$10,219,499	$8,506,168		
Operating Income Deficiency	$5,794,198	$2,648,858	$1,670,416	$5,778,377		
Gross Revenue Conversion Factor	1.6649	1.636969	1.6370	1.6370	Error in the UNSG original gross-up formula as filed.	Kissinger
Increase in Gross Revenue Requirement	$9,646,901	$4,336,098	$2,734,443	$9,459,023		